FILED

94 433 SEP - 9 1994

OFFICE OF THE CLERK

No. —

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUR and HUGH REGAN,

Petitioners,

vs.

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK and WILLIAM M. POLLACK TRUST,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

RICHARD G. CUSHING
Counsel of Record
124 David's Hill Road
Bedford Hills, New York 10507
(914) 234-0100

Attorney for Petitioners

DAVID T. EAMES
G. WADE LEAK
BODIAN & EAMES
Of Counsel

QUESTION PRESENTED

Whether the Court of Appeals for the Second Circuit erred in holding that participations in individual commercial mortgages sold by a mortgage broker to a professional money manager were securities within the meaning of the federal securities laws?

PARTIES

The names of all the parties to the proceeding in the court whose judgment is sought to be reviewed here appear in the caption of the case except Walter L. Twiste.

Laidlaw Holdings, Inc. is the parent corporation of Laidlaw Equities, Inc. and Laidlaw Holdings Asset Management, Inc.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
PARTIES	ii
TABLE OF CONTENTS	iii
TABLE OF AUTHORITIES	v
OPINIONS BELOW	1
STATEMENT OF JURISDICTION	2
STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	4
A. Statement of Facts	6
B. Prior Proceedings	7
REASONS FOR GRANTING THE WRIT	9
THE COURT OF APPEALS MISAPPLIED THE FACTORS ADOPTED BY THIS COURT IN *REVES*	9
1. The Court of Appeals Misapplied The First Three *Reves* Factors By Failing To Focus On The Proper "Purchaser"	10
2. The Court of Appeals' Holding As To The Seller's Motivations Conflicts With A Decision Of The Tenth Circuit	11
3. The Court of Appeals' Misapplication Of The *Reves* Factors Conflicts With This Court's Holding In *Santa Fe*	12

Page

4. The Court of Appeals Misapplied The Fourth *Reves* Factor 13

CONCLUSION 16

APPENDIX

Appendix A - Opinion and Order of the United States Court of Appeals for the Second Circuit, Dated June 22, 1994 ..... A-1

Appendix B - Opinion and Order of the United States District Court for the Southern District of New York, Dated January 19, 1993 ..... B-1

Appendix C - Opinion and Order of the United States District Court for the Southern District of New York, Dated June 25, 1993 ..... C-1

Appendix D - Amended Complaint, Dated June 28, 1991 ..... D-1

TABLE OF AUTHORITIES

CASES	Page
American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981)	10
Banco Espanol De Credito v. Security Pacific Nat'l Bank, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 113 S. Ct. 2992 (1993)	10
Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co., Inc., 800 F.2d 177 (7th Cir. 1986)	12
First Financial Federal Sav. & Loan Ass'n v. E.F. Hutton Mortgage Corp., 834 F.2d 685 (8th Cir. 1987)	10
First State Bank of Wheatland v. American Nat'l Bank, 690 F. Supp. 967 (D. Wyo. 1988)	10
Forkin v. Rooney Pace, Inc., 804 F.2d 1047 (8th Cir. 1986)	13
In re: Epic Mortgage Ins. Litigation, 701 F. Supp. 1192 (E.D. Va. 1988), *aff'd in part, rev'd in part*, 910 F.2d 118 (4th Cir. 1990)	10
Marine Bank v. Weaver, 455 U.S. 551 (1982)	12
McVay v. Western Plains Service Corp., 823 F.2d 1395 (10th Cir. 1987)	10
Pross v. Katz, 784 F.2d 455 (2d Cir. 1986)	13
Resolution Trust Corp. v. Stone, 998 F.2d 1534 (10th Cir. 1993)	11, 12

	Page
Reves v. Ernst & Young, 494 U.S. 56 (1990)	*passim*
Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977)	5, 12
Singer v. Livoti, 741 F. Supp. 1040 (S.D.N.Y. 1990)	15
International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979)	13
Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979)	14
United Housing Foundation v. Forman, 421 U.S. 837 (1975)	15
Wolf v. Banco Nacional de Mexico, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985)	15
STATUTES	
15 U.S.C. § 77b	2
15 U.S.C. § 78c(a)(10)	2
15 U.S.C. § 78j(b)	3
15 U.S.C. § 80b-1 *et seq.*	13
15 U.S.C. § 80b-6	3, 14
15 U.S.C. § 80b-9	14
15 U.S.C. § 80b-15	14
28 U.S.C. § 1254(1)	2
28 U.S.C. § 1292(b)	8

	Page
29 U.S.C. § 1001 *et seq.*	8
29 U.S.C. § 1109	4, 15
N.Y. Banking L. § 595-a(1)(f) (McKinney 1990)	15
OTHER AUTHORITIES	
"Court Watch: Business Decisions", *National Law Journal*, July 11, 1994, at B3	5
Martin Flumenbaum and Brad S. Karp, "Securities Law: Mortgage Participations", *New York Law Journal*, July 27, 1994, at 3	5
"Mortgage Participations Constituted 'Securities' Second Circuit Concludes", *Securities Regulation and Law Report*, July 1, 1994, at 936	5
Sarah Sullivan, "Pollack v. Laidlaw Holdings Inc.," *New York Law Journal*," June 30, 1994, at 5	5
Scott E. Mollen, "Realty Law Digest: Mortgage Participations Held to Be Securities", *New York Law Journal*, July 27, 1994, at 5	5
"Securities", *Connecticut Law Tribune*, July 18, 1994, at 7A	5

No. —

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUR and HUGH REGAN,

Petitioners,

VS.

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK and WILLIAM M. POLLACK TRUST,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit is reported as *Pollack, et al. v. Laidlaw Holdings, Inc., et al.* and appears in Appendix A hereto. The decision of the United States District Court for the Southern District of New York is reported as *Pollack, et al. v. Laidlaw Holdings, Inc.,*

et al. and appears in Appendix B hereto. The opinion of the District Court certifying for interlocutory appeal the question of whether the mortgage participations were securities within the meaning of the federal securities laws appears in Appendix C hereto.

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Second Circuit was entered on June 22, 1994. Jurisdiction to review the judgment by petition for writ of certiorari is based upon 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 2(1) of the Securities Act of 1933, 15 U.S.C. §77b, provides in relevant part:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), provides in relevant part:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The Investment Advisers Act of 1940, 15 U.S.C. § 80b-6, provides in relevant part:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> * * *
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

The Employee Retirement Income Security Act, 29 U.S.C. §1109, provides in relevant part:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

STATEMENT OF THE CASE

This petition is filed on behalf of Laidlaw Holdings, Inc., Laidlaw Equities, Inc., Laidlaw Holdings Asset Management, Inc., Gottfried von Meyern-Hohenberg, Michael F. Fahey, Jr., David N. Bottoms, Walter H. Baur and Hugh Regan (collectively the "Laidlaw defendants"). The important issue raised

by this case concerns the definition of a "security": whether participations in individual commercial mortgages sold by a professional mortgage broker to a licensed professional money manager are "notes" within the meaning of the federal securities laws. The opinion below conflicts with the decisions of this Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), and *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977). In addition, the Court of Appeals' decision raises conflicts between the Circuits with respect to the application of *Reves*.

This case presents an issue of great practical significance to this country's financial services, banking and real estate industries.[1] Prior to the decision below, the cases, including the District Court decision in this action, uniformly held that participations in commercial mortgages were not within the ambit of the federal securities laws. Professionals have been free to trade these instruments without burdensome and costly registration as securities, and the potential impact of the Court of Appeals' decision on the secondary mortgage market could be staggering.

The District Court, recognizing the importance of the issue in this "evolving" area on the "fringe" of the law, certified the issue for interlocutory appeal. App. C-6. On appeal, the Securities and Exchange Commission submitted an *amicus curiae* brief to address this "important question concerning the definition of a 'security'", stressing "the potential impact of a decision in this case on the Commission itself" which would

---

[1] This case has already received extensive attention in the press. *See, e.g.*, Sarah Sullivan, "Pollack v. Laidlaw Holdings Inc.", *New York Law Journal*, June 30, 1994, at 5; "Mortgage Participations Constituted 'Securities' Second Circuit Concludes", *Securities Regulation and Law Report*, July 1, 1994, at 936; "Court Watch: Business Decisions", *National Law Journal*, July 11, 1994, at B3; "Securities", *Connecticut Law Tribune*, July 18, 1994, at 7A; Martin Flumenbaum and Brad S. Karp, "Securities Law: Mortgage Participations", *New York Law Journal*, July 27, 1994, at 3; Scott E. Mollen, "Realty Law Digest: Mortgage Participations Held to Be Securities", *New York Law Journal*, July 27, 1994, at 5. These articles have emphasized the far-reaching ramifications of the Court of Appeals' opinion.

"directly affect the Commission's regulatory and enforcement activities under the Acts."

In this case, a professional money manager who was licensed under the Investment Advisers Act of 1940 purchased participations in individual commercial mortgages for accounts under his control. The money manager had complete discretion over the funds in the customers' accounts and the customers had no involvement in the transactions. In reaching its conclusion that the mortgage participations were securities, the Court of Appeals focused on the beneficial owners' alleged lack of sophistication and their allegation that they wanted their funds invested safely, giving no significance to the fact that the transactions were between sophisticated professionals.

In so holding, the Court of Appeals misapplied the test established by this Court in *Reves* and disregarded the basic premise of *Reves* that the economic reality of the transaction should determine whether or not the transaction involves a security. Here, the economic reality of the transactions was that they involved the sale of commercial loans between professionals. Under the inconsistent logic of the Court of Appeals' decision, the nature of an underlying instrument is determined by the sophistication of the beneficial owner, when that beneficial owner has delegated complete authority and control over his funds to the professional.

The fiduciary responsibilities of a professional money manager are firmly rooted in and regulated under the Investment Advisers Act of 1940, the Employee Retirement Income Security Act and under state common law. Plaintiffs already have a variety of remedies and the SEC already has the authority to regulate such fiduciaries without expanding the definition of a security and requiring the registration of commercial loans under the securities laws.

A. *Statement of Facts*

As alleged in the amended complaint, plaintiffs are orthopedic doctors and their trusts. App. D-2, ¶¶ 4-6. In the early 1970's,

Drs. Pollack and Ariosta opened accounts with defendant Walter L. Twiste, while Twiste was at another firm. App. D-6, ¶ 20. Twiste also became the trustee of Dr. Pollack's trusts. App. D-3, ¶ 7. Twiste later became affiliated with the companies that allegedly became the Laidlaw corporate defendants. App. D-4, ¶ 12; D-6, ¶ 21.

According to the amended complaint, plaintiffs opened managed accounts with the Laidlaw defendants. App. D-7, ¶ 24. Twiste managed those accounts with full discretion and made all decisions concerning transactions for those accounts. App. D-6-7, ¶¶ 21-24. Laidlaw Holdings Asset Management, Inc. was an investment adviser registered with the SEC pursuant to § 203(c) of the Investment Advisers Act of 1940, and was paid an advisory fee pursuant to an investment advisory agreement. App. D-1, ¶ 10. Between November 1985 and January 1988, Twiste purchased participations in individual real estate mortgages for these managed accounts from Eagle Funding, a mortgage brokerage firm. App. D-8, ¶ 26; D-10, ¶ 32.

Twiste did not consult plaintiffs in connection with these purchases, as he had full discretion over their funds. App. D-7, ¶ 24. Plaintiffs were not aware that the mortgage participations were purchased from Eagle Funding and were not shown any documentation concerning the mortgage purchases. App. D-7, ¶ 25. Twiste, however, allegedly told plaintiffs, *after* he made several purchases, that the mortgage loans were "short-term bridge loans for construction and cooperative conversions," and that the mortgage participations were "sound, guaranteed and secured." *Id.*

Plaintiffs received interest payments on the mortgage participations for four years, until May 1989. App. D-11, ¶ 35. After May 1989, plaintiffs ceased receiving payments on the mortgages and Eagle Funding filed for bankruptcy in May 1990. App. D-11, ¶ 37.

B. *Prior Proceedings*

Plaintiffs filed their original complaint in September 1990. In addition to state law claims, plaintiffs asserted claims under

the federal securities laws and the Racketeer Influenced Corrupt Organizations Act ("RICO"). The Laidlaw defendants moved to dismiss the complaint on November 16, 1990. Prior to a decision on that motion, plaintiffs filed an amended complaint in July 1991. The Laidlaw defendants then moved to dismiss the amended complaint on the ground, *inter alia*, that the mortgage participations purchased by plaintiffs were not "securities" under the federal securities laws. The District Court, in a decision dated January 19, 1993, dismissed the complaint in its entirety, finding that the mortgage participations were neither "notes" nor "investment contracts" under the securities laws. App. B-9, B-11. The Court also held that plaintiffs' RICO claims failed to state a claim and that there was no jurisdiction over the pendent state claims.

After the District Court's January 1993 decision, plaintiffs moved to amend their complaint to add a claim under the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. § 1001 *et seq.* At or around the same time, plaintiffs requested that the District Court certify its January 1993 order for interlocutory review under 28 U.S.C. § 1292(b). The District Court granted the request in part and certified for review the question of whether the commercial mortgage participations were securities. In so doing, the District Court emphasized that the question presents "an issue that is on the fringe of the law" and that "there is substantial ground for difference of opinion in this area of the law that has, as yet, undefined boundaries." App. C-6. On appeal, the Securities and Exchange Commission filed an *amicus curiae* brief urging reversal of the ruling on this "important question" that would "directly affect the Commission's regulatory and enforcement activities under the Acts."

The Court of Appeals for the Second Circuit, in a decision dated and entered June 22, 1994, held that the mortgage participations were "notes" under the securities laws. The Court found that plaintiffs, by "pursuing what they believed was a conservative investment strategy through registered professionals in the securities industry . . .[,] believed they were protected by the federal securities laws." App. A-12. Although the Court

of Appeals recognized that the mortgage participations were "commercial loan transactions" and that plaintiffs had absolutely no involvement in the transactions, the Court focused on plaintiffs' lack of sophistication in determining that the underlying instruments were securities. *Id.* The Court found that these unsophisticated plaintiffs "believed that all of the money in their discretionary accounts was being invested, in accordance with their wishes, rather than being used in commercial loan transactions," and accordingly that these commercial loan transactions were securities under the federal securities laws. *Id.*

REASONS FOR GRANTING THE WRIT

THE COURT OF APPEALS MISAPPLIED THE FACTORS ADOPTED BY THIS COURT IN *REVES*

The decision by the Court of Appeals for the Second Circuit conflicts with this Court's decision in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). As this Court made clear in *Reves*, the guiding principle in determining whether an instrument is a "security" is to "take account of the economics of the transaction under investigation." *Id.* This Court in *Reves* adopted a four-factor "family resemblance" test to determine whether a transaction involves a "note" under the federal securities laws:

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. . . . Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment" . . . . Third, we examine the reasonable expectations of the investing public . . . . Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

Reves, 494 U.S. at 66-67 (citations omitted).[2]

1. The Court of Appeals Misapplied The First Three *Reves* Factors By Failing To Focus On The Proper "Purchaser"

The fatal flaw in the Court of Appeals' decision is apparent in its application of the first three *Reves* factors. The mortgage participations here were purchased by plaintiffs' professional money manager, without the involvement or knowledge of plaintiffs. Plaintiffs' alleged lack of sophistication had no bearing on the transactions, which were accomplished by a professional with discretion over their funds. The Court of Appeals confused the beneficial owners' alleged expectations and sophistication with those of the actual purchaser.

By focusing on the beneficial owners' alleged lack of sophistication, the Court of Appeals causes the definition of a security to be determined by an element which was intentionally and contractually removed from the equation. The purpose of entering into an agreement to place funds into a managed account is to grant full authority to the account manager to

---

[2] Prior to the decision below, the cases overwhelming held that participations in commercial loans were not securities. *Banco Espanol De Credito v. Security Pacific Nat'l Bank*, 973 F.2d 51, 56 (2d Cir. 1992) ("loan participations . . . are analogous to the enumerated category of loans issued by banks for commercial purposes"); *McVay v. Western Plains Service Corp.*, 823 F.2d 1395, 1399 n.4 (10th Cir. 1987) (participation certificates in mortgage loans "are neither stocks nor securities"); *American Fletcher Mortgage Co. v. U.S. Steel Credit Corp.*, 635 F.2d 1247, 1253 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981) (mortgage loan participations "were not securities"); *In re Epic Mortgage Insurance Litigation*, 701 F. Supp. 1192, 1248 (E.D. Va. 1988), *aff'd in part, rev'd in part*, 910 F.2d 118 (4th Cir. 1990) (sales of mortgage participations "were commercial transactions and not 'investments', to which federal securities laws would apply."); *First State Bank of Wheatland v. American Nat'l Bank*, 690 F. Supp. 967, 970 (D. Wyo. 1988) ("loan participation agreements were not securities within the intent of the federal securities laws"); *see also First Financial Federal Sav. & Loan Ass'n v. E.F. Hutton Mortgage Corp.*, 834 F.2d 685 (8th Cir. 1987) (mortgage purchase did not involve a security).

perform all transactions and make all purchasing decisions for those funds. By the terms of a written agreement, plaintiffs replaced themselves with a professional representative with respect to the plan of distribution of all instruments purchased for their managed accounts.

The decision of the Court of Appeals stands *Reves* on its head. Under the *Reves* family resemblance test, if the transaction resembles a commercial transaction, then the instrument is "less sensibly described as a 'security.'" 494 U.S. at 66. According to the reasoning of the decision below, because plaintiffs "believed that all of their money was being invested, in accordance with their wishes, rather than being used in commercial loan transactions" (App. A-12), the underlying commercial mortgage participations somehow became securities. The issue, however, of whether the money manager deviated from a client's instructions should have no bearing on whether an instrument is a security.

2. The Court of Appeals' Holding As To The Seller's Motivations Conflicts With A Decision Of The Tenth Circuit

Reves also addresses the motivation of the seller of the instrument. The Court of Appeals recognized that this case presented a "close question" as to the seller's motivations (App. A-9), yet held that they were not commercial. The Court of Appeals' holding is in conflict with a recent decision by the Tenth Circuit.

In *Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993), the Tenth Circuit held that the seller's motivation in a transaction remarkably similar to plaintiffs' purchase of the mortgage participations was commercial. In *Stone*, a company purchased "consumer automobile notes from car dealers, repackag[ed] them with certain additional features, and [sold] them to purchasers" like the plaintiff. *Id.* at 1536. Applying the first *Reves* factor, the court held:

> Here, [the company] was not selling the [automobile receivables] for general investment in [the company];

> rather it was selling its stock-in-trade. [Automobile receivables] was a product that [the company] sold as part of its on-going business activity. Although the buyers obviously hoped to profit from the inherent value of the product purchased, that expected profit was not tied to the profitability of [the company]. Instead, the motivation of both parties appears to have been to enter into a commercial transaction.

Id. at 1539. Just as repackaged automobile notes were the stock-in-trade of the defendant in *Stone*, Eagle Funding was a mortgage broker, whose on-going business was buying and selling mortgages and mortgage participations. The Court of Appeals' conclusion with respect to this factor, which conflicts with the Tenth Circuit's recent decision in *Stone*, also warrants review by this Court.

3. The Court of Appeals' Misapplication Of The *Reves* Factors Conflicts With This Court's Holding In *Santa Fe*

The decision below also conflicts with the reasoning of this Court in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977). In *Santa Fe*, this Court held that the securities laws do not provide a remedy for breach of fiduciary duty and that Congress did not intend to provide a remedy under § 10(b) for fraudulent conduct unless it satisfied the strict requirements of that section. *Id.* at 472-73; *see also Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) ("[W]e are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad remedy for all fraud."). In this case, the Court of Appeals did exactly what *Santa Fe* held is impermissible – extend the securities laws to cover allegations of breaches of fiduciary duties.

The Court of Appeals' reasoning also conflicts with earlier Second Circuit authority and the decisions of other Circuits. *See Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co., Inc.*, 800 F.2d 177, 181 (7th Cir. 1986) (refusing to extend the protections of section 10(b) and Rule 10b-5

"when the plaintiff transferred to [its investment adviser] full authority to make investment decisions" and plaintiff "made no investment decisions."); *Forkin v. Rooney Pace, Inc.*, 804 F.2d 1047, 1050 (8th Cir. 1986) ("The reasons behind limiting section 10(b) and Rule 10b-5 to instances of actual fraud is clear. If they were not so limited, every instance of broker misconduct would give rise to a cause of action under the anti-fraud provisions of the federal securities laws."); *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986) ("We are unwilling to extend the reach of the securities laws to every conversion or theft of a security."). Here, by recognizing a securities fraud claim for every transaction allegedly contrary to the customers' desires, the Court below extended the securities laws in precisely the manner that consistently has been rejected by the courts.

4. The Court of Appeals Misapplied The Fourth *Reves* Factor

The final *Reves* factor involves a determination of "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." 494 U.S. at 67. The Court of Appeals rejected the District Court's holding that the mortgage participations were sufficiently regulated under state law and the argument by the Laidlaw defendants that there was already sufficient federal and state regulation that made application of the securities laws unnecessary. App. B-9.

In *Reves*, this Court held that, because the transaction at issue was not regulated by any other federal statute, plaintiffs would be unprotected if the securities laws did not apply. The *Reves* Court distinguished the transaction from another involving a pension plan that was "comprehensively regulated under [ERISA]." 494 U.S. at 69 (citing *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 569-70 (1979)). In the case at bar, two applicable risk-reducing regulatory federal statutes, the Investment Advisers Act of 1940 (the "IAA"), 15 U.S.C. § 80b-1 *et seq.*, and the Employee Retirement Income Security Act, apply to the relationship between the money manager and his client. In

addition, the underlying instruments are traditionally subject to state regulation.

The IAA provides for comprehensive regulation of investment advisers, including licensing. Section 80b-6 of the IAA makes it unlawful for an investment adviser:

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> * * *
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

The anti-fraud provisions in the IAA clearly cover all activities of the investment adviser that affect the client.

The IAA gives the SEC extremely wide latitude to investigate and prosecute violations of the Act. *See* 15 U.S.C. § 80b-9. The IAA also provides civil and criminal mechanisms to address improper conduct, including a private right of action for aggrieved clients of an investment adviser for rescission of the contract and restitution of all fees. 15 U.S.C. § 80b-15; *see Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979). The IAA clearly was a risk-reducing factor that was in place here.[3]

In addition, two of these plaintiffs, owning approximately half of the mortgage participations, are ERISA plans. App. D-33.

---

[3] After a thorough investigation prompted by notification from Laidlaw, the SEC concluded that violations of the anti-fraud provisions of the Investment Advisers Act and of net capital requirements under the Securities Exchange Act were "solely due to the actions of Twiste" and barred Twiste from any association with an investment adviser or broker/dealer. Laidlaw was neither fined nor censured, but agreed to establish new procedures and conduct reviews for two years.

ERISA provides employee pension plans with a broad civil remedy for breaches of fiduciary duty:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

29 U.S.C. § 1109. Plaintiffs have sought leave to amend the complaint to include ERISA claims, like those distinguished in *Reves*.

Finally, as recognized by the District Court, under New York state law, extensive statutory regulation of mortgages and mortgage brokers already exists. *See, e.g.*, N.Y. Banking L. § 595-a(1)(f) (McKinney 1990) (New York banking board regulation shall encompass "*any* transaction, practice, or course of business which *operates as a fraud* upon any person in connection with the *purchase or sale of any mortgage loan*"); *Singer v. Livoti*, 741 F. Supp. 1040 (S.D.N.Y. 1990) (discussing public recordation of mortgages and state fidelity system). Both the adviser/client relationship and mortgage instruments are already subject to extensive regulation, and subjecting mortgages to additional regulation as securities is unnecessary.[4]

---

[4] The Court also found that, since existing state regulation was insufficient, it need not decide the question of "whether state law can be the source of such alternative protection." App. A-13. The reasoning of this Court and the Ninth Circuit, however, suggests that federal law is not the exclusive source of alternative regulation. In *United Housing Foundation v. Forman*, 421 U.S. 837 (1975), this Court looked to state housing law in determining that real estate investments were not securities. *See also Wolf v. Banco Nacional de Mexico*, 739 F.2d 1458, 1463 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985) (certificates of deposit not securities when they were regulated by Mexican law). The need for a definitive ruling on this unsettled question is yet another reason for review by this Court.

CONCLUSION

For the reasons set forth above, a writ of certiorari should be issued to review the opinion and judgment of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

RICHARD G. CUSHING
124 David's Hill Road
Bedford Hills, New York 10507
(914) 234-0100
Counsel of Record and Attorney for Petitioners Laidlaw Holdings, Inc., Laidlaw Equities, Inc., Laidlaw Holdings Asset Management, Inc., Gottfried von Meyern-Hohenberg, Michael F. Fahey, Jr., David N. Bottoms, Walter H. Baur and Hugh Regan

DAVID T. EAMES
G. WADE LEAK
BODIAN & EAMES
Of Counsel

September 8, 1994

APPENDIX

BEST AVAILABLE COPY

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 1149 August Term 1993

Argued: March 10, 1994 Decided: June 22, 1994

Docket No. 93-7993

STEPHEN J. POLLACK, et al.,

Plaintiffs-Appellants,

– against –

LAIDLAW HOLDINGS, INC., et al.,

Defendants-Appellees.

Before: LUMBARD, FEINBERG and MINER, Circuit Judges.

Interlocutory appeal, pursuant to 28 U.S.C. § 1292(b), from dismissal of complaint alleging violations of the federal securities laws, RICO and state law in connection with purchase and sale of mortgage participations. The question is whether certain mortgage participations were "securities" within the coverage of the federal securities laws. The district court held that they were not.

Circuit court reverses and remands.

STEVEN M. EDWARDS, New York, NY (Davis, Scott, Weber & Edwards, P.C., Ellen Wahl Parker, Jonathan A. Greenberg, of Counsel), for Plaintiffs-Appellants.

RICHARD G. CUSHING, New York, NY (David T. Eames, G. Wade Leak, Bodian & Eames, New York, NY, of Counsel), for Defendants-Appellees.

Simon M. Lorne, General Counsel, Jacob H. Stillman, Associate General Counsel, Eric Summergrad, Principal Assistant General Counsel, Randall W. Quinn, Senior Litigation Counsel, Paul Gonson, Solicitor, of Counsel, Securities and Exchange Commission, Washington, DC, Amicus Curiae.

FEINBERG, Circuit Judge:

This is an interlocutory appeal, pursuant to 28 U.S.C. § 1292(b), from an order issued in January 1993 in the United States District Court for the Southern District of New York, Peter K. Leisure, J., dismissing claims brought under the federal securities laws, RICO and state law. Plaintiffs-appellants are two doctors, the son of one of them, the personal retirement plans of the doctors (and their employees) and a family trust of one of the doctors (collectively, Pollack or appellants). Defendants-appellees are corporate entities in the securities and investment counselling business and the officers of these corporations (collectively, Laidlaw or appellees). Pollack claims that Laidlaw fraudulently invested Pollack's funds in "uncollateralized, speculative participations in mortgages," some of which were "fictitious and oversubscribed," resulting in a loss of more than one million dollars. After the district court's January 1993 order, Pollack requested the court to certify the order for interlocutory review under 28 U.S.C. § 1292(b). The court granted the request in a brief opinion, which described the "controlling question of law" as whether the participations constitute "securities" under federal law. For reasons set forth below, we answer the question in the affirmative, reverse the order of the district court and remand for further proceedings.

I. Background

The order appealed from dismissed Pollack's securities claims pursuant to Fed. R. Civ. P. 12(b)(6). For the purpose of this appeal, therefore, we accept as true all of the factual allegations in the complaint, and draw all inferences in favor of Pollack. The following statement of facts is taken from the amended complaint and from the opinion of the district court.

A. Factual Allegations

Appellants are passive, unsophisticated investors, who relied on professionals to manage their money. In the 1970s, they began dealing with Walter L. Twiste, a broker and investment advisor. This relationship continued beyond 1977, when Twiste began an association with the companies that allegedly became the Laidlaw corporations. As of May 1990, appellants' accounts with Laidlaw exceeded $3.5 million. This money was in discretionary accounts, and Laidlaw received an investment management fee on the portfolio as well as commissions on executed transactions. Appellants received by mail written confirmation of all transactions, as well as monthly statements.

Appellants' standing instruction to Laidlaw was to pursue conservative, low-risk investments. For example, appellants' portfolio consisted mostly of investment grade bonds and other debt instruments, rather than equities or "junk" bonds. Appellants allege that in 1985 they noticed references to "promissory notes" connected to various properties. Twiste told appellants that these were mortgages, primarily short-term bridge loans for construction and cooperative conversions, and that the mortgages were "sound, guaranteed and secured," consistent with appellants' investment objectives.

In June 1990, appellants learned that Twiste had left Laidlaw and had been admitted into a mental institution; Laidlaw informed them that Twiste had committed "serious acts of fraud," including stealing money from clients' accounts. At approximately the same time, appellants found out that the mortgage investments were the result of transactions with Eagle S.A Funding Company (Eagle), an entity of whom appellants had never

heard. In May 1990, one of the Eagle partners had committed suicide and the company had gone into bankruptcy. Allegedly, Laidlaw had failed to investigate the mortgage investments obtained through Eagle, and Twiste was receiving commissions from Eagle as well as from Laidlaw. Appellants also found out that the mortgage participations, which had terms of approximately one to three years, were not secured, as represented by Twiste. Many of the underlying mortgages were unsecured and unrecorded. Appellants' interests in the mortgages were uncollateralized and speculative at best, and "fictitious and/or oversubscribed" at worst, but from 1985 to 1989 appeared to provide satisfactory returns because funds of new investors were used to make payments on existing accounts. Although Eagle stopped making payments in May 1989, Laidlaw continued to send appellants portfolio evaluations from May 1989 to June 1990 showing allegedly fictitious interest and principal payments.

B. Proceedings in the District Court

After some initial cooperation from Laidlaw, followed by failed settlement discussions, appellants determined that they had suffered a loss of $1,093,924. In September 1990, Pollack filed the original complaint. Laidlaw moved to dismiss the complaint based mainly on lack of particularity under Fed. R. Civ. P. 9(b).

Prior to the disposition of that motion, appellants took Twiste's deposition. Twiste admitted to misrepresenting the mortgage interests, receiving kickbacks and making fictitious entries in appellants' statements, and he described the mortgage interests in greater detail. Appellants then filed an amended complaint in June 1991.[1]

Count I of the complaint alleged the sale of unregistered securities in violation of §§ 5(a), 5(c) and 12(1) of the Securities Act of 1993, 15 U.S.C. §§ 77e(a), 77e(c) and 77l(1). Count II

---

[1] In May 1991, the Securities and Exchange Commission (SEC) initiated proceedings against Twiste and Laidlaw, which culminated in remedial sanctions.

alleged misrepresentations and omissions in violation of § 12(2) of the 1933 Act, 15 U.S.C. § 77l(2). Count III alleged securities fraud in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. Counts IV and V alleged violations of RICO, 18 U.S.C. § 1962(c), and counts VI through X alleged pendent state claims based on breach of fiduciary duty, conversion, fraud and deceit, negligent misrepresentation and misrepresentation. Appellants requested not less than $1,093,924 in damages or as a part of a rescission remedy, $10 million in punitive damages, interest income, treble damages under RICO and costs.

The Laidlaw defendants again moved to dismiss, and in January 1993 the district court granted the motion. The district court ruled that: (1) the securities claims should be dismissed pursuant to Fed. R. Civ. P. 12(b)(6) because the mortgage participations were not securities; and (2) the RICO claims should be dismissed pursuant to Fed. R. Civ. P. 9(b) for failure to plead fraud with particularity on the part of Laidlaw, and pursuant to Rule 12(b)(6) because under RICO Laidlaw could not be held liable for Twiste's acts on a theory of respondeat superior. The district court declined to exercise supplemental jurisdiction over the state law claims, but granted appellants leave to file an amended complaint to replead the RICO counts as well as the pendent claims.

Appellants then moved to file a second amended complaint to cure the Rule 9(b) defects. At the same time, appellants sought to add one count under the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1001 et seq., and moved for certification of the January 1993 order. Laidlaw did not oppose certification.

In June 1993, the district court issued an opinion and order granting the motion for certification. The district court held that the securities issue was appropriate for certification, noting that "[w]hether the mortgage participations purchased on behalf of the plaintiffs were securities is an issue that is on the fringe of the law in this developing area." However, the district court did not certify the issue of vicarious liability under RICO, both

because appellants were granted leave to replead to establish Laidlaw's direct liability under RICO and because the district court believed that there was not "substantial ground for difference of opinion" as to its holding that there is no vicarious liability under RICO.[2]

In September 1993, this court permitted the appeal. Thereafter, the SEC sought, and obtained, permission to file an amicus brief in support of appellants' view that the interests sold in this case are securities.

II. Discussion

This appeal requires us to engage again in the difficult task of applying the legislative definition of "security." See Louis Loss & Joel Seligman, 2 Securities Regulation 869-71 & n.5 (3d ed. 1989) (noting dissatisfaction with judicial efforts in this area). Appellants and the SEC argue that the district court erred in dismissing their claims under the federal securities laws, because the mortgage participations were securities under both section 2(1) of the 1993 Act, 15 U.S.C. § 77b(1), and section 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10). Specifically, appellants allege that the mortgage participations were notes and investment contracts, two types of instruments regulated under the federal securities laws.[3] While the definitions of securities in the 1993 and 1934 Acts are not identical, the definitions are treated as identical in "decisions dealing with the scope of the term." Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985).

A. The *Reves* Factors

We must determine whether the mortgage participations are regulated by the securities acts by applying the "family

---

[2] Appellants argue that the district court erred in deciding the RICO vicarious liability issue. In light of the district court's view that the requirements of 28 U.S.C. § 1292(b) were not met with respect to that issue, we decline the invitation to decide it on this interlocutory appeal.

[3] The SEC confines itself to arguing that the participations were notes. Although the arguments of appellants and the SEC on this issue differ in minor respects, we consider them together under the general rubric of "appellants."

resemblance" test enunciated by the Supreme Court in Reves v. Ernst & Young, 494 U.S. 56 (1990). See Banco Espanol de Credito v. Security Pac. Nat'l Bank, 973 F.2d 51, 55 (2d Cir. 1992), cert. denied, 113 S. Ct. 2992 (1993). Under the family resemblance test, a note is presumed to be a security unless the note resembles one of the several judicially-enumerated instruments that are not securities. Reves, 494 U.S. at 65 (citing Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976); Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 939 (2d Cir.), cert. denied, 469 U.S. 884 (1984)).[4] In applying this test, we look to four factors. If the note is not sufficiently similar to one of the non-security instruments, then we must determine whether another category of such instruments should be judicially created by reference to the same four factors, identified in *Reves* as follows:

> (1) the motivations that would prompt a reasonable buyer and seller to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary.

Banco Espanol, 973 F.2d at 55 (citing Reves, 494 U.S. at 66-67). In using this analysis, it is important to bear in mind that

---

[4] In *Reves*, the Supreme Court identified the types of notes that are not securities as:

> the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a character loan to a bank customer, short-term notes secured by an assignment of accounts receivable, . . . a note which simply formalizes an open-account debt incurred in the ordinary course of business . . . [and] notes evidencing loans by commercial banks for current operations.

494 U.S. at 65 (citations and quotations omitted).

"a participation in an instrument might in some circumstances be considered a security even where the instrument itself is not." Id. at 54; see also Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230, 240-42 (2d Cir. 1985).

The district court recognized that notes secured by a mortgage on a home, in the traditional mortgage transaction, are among the enumerated categories of non-securities. See Exchange Nat'l Bank, 544 F.2d at 1138. The district court then examined the mortgage interests at issue by reference to the *Reves* factors and concluded that they were not "notes" within the scope of the 1933 and 1934 Acts.

We disagree, and we hold that the instruments here are "notes" within the meaning of the securities acts.[5] For reasons that will become clear as we address each of the four *Reves* factors, we believe that these instruments do not sufficiently resemble the traditional note secured by a home mortgage to be exempt from regulation under the securities laws. Nor do we believe that the *Reves* factors warrant the creation of an additional category of non-securities for these instruments.

B. Application of the *Reves* Factors

1. The Motivations of Buyer and Seller

The first *Reves* factor requires a court to "examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it." 494 U.S. at 66. The inquiry is whether the motivations are investment (suggesting a security) or commercial or consumer (suggesting a non-security).

The district court found that the buyers and seller of the mortgage participations were motivated by commercial rather than investment considerations. The court stated that "the complaint indicates that the loan proceeds were to be used for cooperative

---

[5] In view of our holding, we do not find it necessary to decide whether, as appellants argue, the mortgage participations are also investment contracts under SEC v. W.J. Howey Co., 328 U.S. 293 (1946), regulated by the securities laws.

conversions and renovation of commercial space." The court regarded Eagle as the seller of the mortgage interests, and characterized Eagle's motivations as commercial because it earned a fee for servicing the mortgages while obtaining funds to engage in additional loan transactions. The district court further found that appellants, as buyers, were commercially motivated because they received "interest on their investment at a fixed rate and apparently had no prospect for profits in excess of the interest paid" and personal guarantees by the principals of Eagle.

Appellants argue that this was error in several respects. First, the amended complaint alleged that Laidlaw and Twiste were sellers, as agents of Eagle. Second, the motivations ascribed to Eagle and to appellants by the district court are more properly characterized as investment than commercial.

We agree with appellants that the motivations of the parties to this transaction are more accurately characterized as investment rather than commercial. We acknowledge that this may be a close question with respect to the seller — or sellers. Cf. Resolution Trust Corp. v. Stone, 998 F.2d 1534, 1539 (10th Cir. 1993). Nevertheless, we believe that the somewhat stronger position is that Eagle was raising funds for its general business activities of making and servicing mortgages. This would seem to be an investment motivation because "the seller's purpose [was] to raise money for the general use of a business enterprise or to finance substantial investments." Reves, 494 U.S. at 66. Moreover, with respect to the buyers, we regard motivation as not even a close question. The instruments were obtained for appellants by their investment adviser as part of their investment portfolios. Appellants sought to invest funds in secure, conservative instruments. Most of the instruments that such investors would take positions in, such as investment grade commercial bonds, would have a fixed rate of return in the form of interest. Such bonds are nonetheless regulated as securities. The Supreme Court has specifically recognized that "profit" means " 'a valuable return on an investment,' which undoubtedly includes interest." Reves, 494 U.S. at 68 n.4. We therefore believe that the district court erred in finding that the fixed rate of return cut against the presumption that the notes are securities. Since

the buyers' motivation was so clearly to invest, we would adhere to this view even if we accepted the district court's characterization of Eagle's motivation.

With regard to the effect of the Eagle guarantees, there is a preliminary procedural question: Appellants argue that the district court erred in considering them at all on the basis of unauthenticated documentation submitted with the motion to dismiss, particularly since the documents apparently did not represent all or even most of the transactions at issue. Although this argument is substantial, we need not deal with it.[6] Even on the assumption that there were guarantees, appellants were not directly involved in the transactions, and they had no more opportunity to evaluate the value of the Eagle guarantees than they had to evaluate the underlying mortgages or the participations that they purchased. Moreover, the degree of safety of an investment does not call into doubt the applicability of the securities laws. See Exchange Nat'l Bank, 544 F.2d at 1136 ("the securities laws cover debt, even supposedly gilt-edged debt, as well as equity").

2. The Plan of Distribution

The district court found that appellants' allegations of a broad plan of distribution, encompassing unsophisticated investors, "militate[d] against a finding that the mortgage participations here are not securities." In other words, the plan of distribution supported a finding that regulation of these participations as securities is consistent with Congressional intent to protect unsophisticated investors.

Not surprisingly, appellees take issue with this portion of the district court's analysis. In this context, Laidlaw emphasizes that the mortgage participations were purchased through a

---

[6] Appellants allege that the notes were not guaranteed. Appellees dispute this claim, relying on materials outside of the complaint. Appellants argue that the district court was required either to exclude this evidence or to convert appellees' motion to dismiss to one for summary judgment, and give appellants the opportunity to submit materials in rebuttal. Fonte v. Board of Managers of Continental Towers Condominium, 848 F.2d 24, 25 (2d Cir. 1988).

discretionary account managed solely by Twiste, an experienced and sophisticated investment manager. Therefore, Laidlaw argues, the plan of distribution cuts against application of the securities laws.

We do not agree with this contention. By this argument, Laidlaw may be attempting to bring this case factually closer to *Banco Espanol*, in which we emphasized that restrictions on the marketing of certain loan participations strongly suggested that there was no need for the protection of the federal securities laws. The elements of the plan of distribution that we stressed in *Banco Espanol* included that only institutional and corporate entities were solicited, detailed individualized presentations were made to potential purchasers and resales were prohibited without the express written permission of the broker. 973 F.2d at 55. The marketing scheme in *Banco Espanol* was more analogous to a group of highly sophisticated commercial entities engaging in short-term commercial financing arrangements than to the securities markets. In contrast, the record before us does not suggest that the participations here were restricted to sophisticated investors who had "the capacity to acquire information about the debtor." Id.

In *Banco Espanol*, "we rule[d] only with respect to the loan participations as marketed . . . [and] recognize[d] that even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities." Id. at 56 (citing Gary Plastic Packaging Corp., 756 F.2d at 240-42). The district court in this case correctly concluded that the broad-based, unrestricted sales to the general investing public alleged in the complaint support a finding that these instruments are within the scope of the federal securities laws.

3. The Reasonable Expectations of the Investing Public

Despite finding that the purchasers of these mortgage instruments were unsophisticated, passive investors who had simply placed their money in discretionary accounts with instructions to make conservative investments, the district court

concluded that the "members of the investing public would reasonably expect that the instruments in this case were not securities." Appellants argue that these findings are inconsistent, and point out that they have alleged that they believed that all of the money in their discretionary accounts was being invested, in accordance with their wishes, rather than being used in commercial loan transactions. The district court apparently believed that investors would not expect these interests to be securities because of the fixed interest rate and the Eagle guarantees.

We believe that the district court's analysis of this factor was erroneous. As indicated above, neither the fixed interest rate nor the personal guarantees (assuming they existed) justified characterizing appellants' motivations as anything but investment. Nor do these factors alter the reasonable expectations of investors, pursuing what they believed was a conservative investment strategy through registered professionals in the securities industry, that they were protected by the federal securities laws.

4. Risk-Reducing Factor

In applying the final *Reves* factor, the district court held that federal securities regulation is unnecessary here because collateralized mortgages are regulated under New York State law. The district judge relied on Singer v. Livoti, 741 F. Supp. 1040 (S.D.N.Y. 1990), for the proposition that Congress regarded real property transactions as essentially local in nature and did not "intend[] to sweep them into the statutory scheme for the regulation of securities transactions." Id. at 1051.

Appellants take issue with this analysis on a number of grounds. They point out that the amended complaint specifically alleges that the mortgage participations were "not secured" and were "uncollateralized." Moreover, *Singer* involved "allegations of federal securities fraud on the part of an attorney who helped to arrange financing for a real estate development that later failed." 741 F. Supp. at 1041. In *Singer*, the judge pointed out:

> [Mortgage] instruments are ordinarily generated, as this one was, through the intermediary of a licensed

> professional, such as an attorney, real estate broker or mortgage broker. New York maintains a complete statutory scheme to assure fidelity of these professionals to their clients and customers . . . . Furthermore, all states provide for public recordation of mortgages, an opportunity for mortgage lenders to search out prior liens and defects in title in the public record before investing, and give statutory protection by such recordation against subsequent encumbrancers of the collateral.

Id. at 1050 (citations omitted). Appellants argue that whatever protections might have been provided in the situation described in *Singer*, they were of little if any use in reducing the risk in the situation before us. Appellants perhaps could have taken discretion from their adviser's hands, conducted face-to-face negotiations with borrowers, inspected the properties involved, checked the records for liens, obtained title insurance and used the services of a lawyer, as persons lending money through mortgages generally do. But, appellants argue, that is not what happened here. Invocation of protections that might apply to the more usual mortgage loan distorts the character of these transactions.

Finally, appellants claim that the fourth *Reves* factor does not contemplate protections under state law, but refers only to protection under federal law that would render application of the securities laws unnecessary.

We agree with appellants that the district court erred in concluding that New York State regulations concerning mortgages afforded protection sufficient to render unnecessary the application of the federal securities laws to these mortgage participations. In doing so, we do not decide whether state law can be the source of such alternative protection, although it is true that the cases on which *Reves* relied in discussing this factor, 494 U.S. at 69, did involve alternative schemes of *federal* regulation. See Marine Bank v. Weaver, 455 U.S. 551, 558 (1982) (federal regulation of banks and FDIC insurance); International Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 569-70 (1979)

(ERISA); see also 2 Loss & Seligman at 877 & n.27. Our holding is limited to the facts as alleged in the complaint, according to which appellants held "uncollateralized, speculative participations in mortgages" and had not engaged in the usual process for extending such a loan.

Appellees argue that appellants did have the protection of federal law, namely the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq., and ERISA. However, we agree with appellants that the former statute was intended to complement, rather than substitute for, the 1933 and 1934 Acts. Laird v. Integrated Resources, Inc., 897 F.2d 826, 834-35 (5th Cir. 1990). With regard to ERISA, it is true that appellants seek to add an ERISA claim in their second amended complaint, but they point out that ERISA would apply to only a small percentage of the participations. Under the circumstances, we need not decide whether appellants are correct in arguing that in this case ERISA "cannot come close to serving as a comprehensive replacement for the federal securities laws."

Thus, on the limited record before us, we conclude that the district court misapplied the *Reves* analysis, and that the mortgage participations as alleged in the complaint are notes within the scope of the federal securities laws.

We reverse the January 1993 order of the district court, and remand the case for further proceedings consistent with this opinion.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK, and WILLIAM M. POLLACK TRUST,	x	
Plaintiffs,	x	
— against —	x	OPINION AND ORDER
LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., WALTER L. TWISTE, GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUER, and HUGH REGAN,	x	90 Civ. 5788 (PKL)
Defendants.	x	

APPEARANCES

DAVIS, MARKEL & EDWARDS
100 Park Avenue
New York, New York 10017
Steven M. Edwards, Esq., *of counsel*
Lynne E. Johnston, Esq., *of counsel*
Andrea L. Leeb, Esq., *of counsel*

ATTORNEYS FOR PLAINTIFFS

RICHARD G. CUSHING, ESQ.
275 Madison Avenue, 12th Floor
New York, New York 10016

BODIAN & EAMES
575 Lexington Avenue, 31st Floor
New York, New York 10022
David T. Eames, Esq., *of counsel*

ATTORNEYS FOR DEFENDANTS

LEISURE, *District Judge*,

Plaintiffs brought this action to recover damages allegedly caused by certain fraudulent representations made by defendant Walter L. Twiste in connection with the acquisition and retention of certain investments by the plaintiffs. Defendants Laidlaw Holdings, Inc. ("Holdings"), Laidlaw Equities, Inc. ("Laidlaw"), Laidlaw Holdings Asset Management ("Laidlaw Asset Management"), collectively the "Laidlaw defendants," and defendants Gottfried Von Meyern-Hohenberg, Michael F. Fahey, Jr., David N. Bottoms, Walter H. Bauer, and Hugh Regan, collectively the "individual moving defendants," move this Court for an order dismissing the amended complaint pursuant to Rules 9(b) and 12(b) of the Federal Rules of Civil Procedure.[1] For the following reasons, defendants' motion is granted in its entirety.

BACKGROUND

Plaintiffs are orthopedic doctors and certain related trusts that maintained accounts with Walter L. Twiste for approximately twenty years. Twiste was employed by defendant Laidlaw beginning in June 1988. The individual moving defendants are officers or directors of Laidlaw and/or its two affiliates, Holdings and Laidlaw Asset Management. Holdings is the corporate parent of Laidlaw and Laidlaw Asset Management. Plaintiffs do not allege that any defendant other than Twiste made any representations of any kind to the plaintiffs or failed to disclose any information that was required to be disclosed to the plaintiffs. Plaintiffs seek to hold the moving defendants liable on theories of control person or vicarious liability.

---

[1] This action was stayed as against defendant Twiste on or about May 7, 1991, when he filed for protection under Chapter 7 of the Bankruptcy Code. Twiste is the sole defendant not joining in the instant motion.

Plaintiffs allege that between 1985 and May 1990, Twiste purchased mortgages and/or participations in mortgages on their behalf from Eagle S.A. Funding Co. ("Eagle Funding"), which is not a party to the instant action. Twiste allegedly informed plaintiffs that the investments "were mortgages, primarily short-term bridge loans for construction and cooperative conversions." *See* Amended Complaint ¶ 25. Plaintiffs allege that the purchases were effected fraudulently because Twiste told them, at numerous times unspecified in the complaint, that the mortgages were "'sound, guaranteed and secured.'" *See* Amended Complaint ¶¶ 25, 26. In fact, plaintiffs allege, many of the mortgages were fictitious or unrecorded second mortgages. *See* Amended Complaint ¶ 32, 33. Plaintiffs did not, however, identify any particular mortgages as unrecorded or fictitious. Plaintiffs further allege that, from May 1989 through June 1990, the defendants falsified entries on the Portfolio Evaluations to conceal the fact that the mortgages became nonperforming in May 1989. *See* Complaint ¶ 35. They fail, however, to identify any particular misrepresentations in any particular documents or the specific defendants involved in the alleged falsification.

The complaint alleges that the plaintiffs received three types of information, at various times, from the Laidlaw defendants: (1) periodic written confirmations of "specific trading activities;" (2) a monthly computer printout from Pershing, a division of Donaldson Lufkin & Jenrette, that was an account listing; and (3) another monthly computer printout entitled "Portfolio Evaluation." *See* Amended Complaint, ¶ 3. These reports and confirmations were delivered to the plaintiffs through the means and instrumentalities of the United States Post Office. *Id.*

The moving defendants moved to dismiss the original complaint on or about November 16, 1990. Prior to decision on that motion, plaintiffs filed an amended complaint in July 1991. The amended complaint contains ten counts. Count I alleges violations of section 12(1) of the Securities Act of 1933 (the "1933 Act") against all defendants. Count II alleges violations of section 12(2) of the 1933 Act against all defendants. Count III alleges violations of section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") against all defendants. Count IV alleges that

Holdings, Laidlaw Asset Management, and Twiste violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1962(c), and that Laidlaw was the RICO enterprise. Count V alleges that Laidlaw, Holdings, Laidlaw Asset Management, and Twiste violated RICO, 18 U.S.C. § 1962(c), and that the relevant enterprise consisted of an association in fact including the Laidlaw defendants and Eagle Funding. Counts VI, VII, VIII, IX, and X assert causes of action arising under state law against the Laidlaw defendants and Twiste concerning: breach of fiduciary duty, conversion, fraud and deceit, negligent misrepresentation, and misrepresentation.

The moving defendants seek an order dismissing the amended complaint with prejudice pursuant to Rules 9(b), 12(b)(1), and 12(b)(6) of the Federal Rules of Civil Procedure. The defendants seek dismissal of the securities and RICO counts on the grounds that these counts each fail to state a claim upon which relief may be granted and fail to plead the allegations of fraud with particularity, as required by Fed. R. Civ. P. 9(b), such that each defendant is not properly informed of his alleged participation in the securities fraud or the predicate acts of the RICO claims. Additionally, the defendants argue that the securities claims fail under Fed. R. Civ. P. 12(b)(1) because the mortgage instruments purchased by plaintiffs are not "securities" within the meaning of the federal securities laws. Defendants also seek dismissal of the pendent state claims if the securities and RICO claims are dismissed, as there is no independent basis for federal jurisdiction over those claims. Finally, the defendants seek the imposition of Rule 11 sanctions against the plaintiffs.

DISCUSSION

I. Securities Claims: Rule 12(b)(6) Considerations: are the Mortgage Participations at Issue Here "Securities"

Defendants move to dismiss the securities claims on the ground that the mortgages and mortgage participations involved in this case are not "securities," as that term is defined in the 1933 Act

and the 1934 Act.[2] Plaintiffs argue in response that the mortgage investments are "notes" or "investment contracts" falling within the scope of the Securities Acts.

Section 3(a)(10) of the 1934 Act defines the term "security":

> The term "security" means any note . . . [or] investment contract . . . , or in general, any instrument known as a "security"; or any certificate of interest or participation in . . . any of the foregoing.

15 U.S.C. § 78c(a)(10). The Court is mindful that the essential purpose of the securities laws is "to eliminate serious abuses in a largely unregulated securities market," *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975), and that the market encompassed within the jurisdiction of the securities laws is broad, *Reves v. Ernst & Young*, 494 U.S. 56, 60-61 (1990). The scope of protection afforded by the securities laws is not, however, unlimited: Congress did not intend to "provide a broad remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

While it is well settled that certificates evidencing loans by commercial banks to their customers for use in current operations, *see, e.g., Reves*, 494 U.S. at 65 (citing *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984)), and notes secured by a mortgage on a home, *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976), are not securities, participations in such interests may in some cases be considered securities even where the underlying instrument is not a security. *Banco Espanol De Credito v. Sec. Pacific Nat'l Bank*, 973 F.2d 51, 54 (2d Cir. 1992), *petition for cert. filed* (Nov. 25, 1992). The Court must consider

---

[2] Defendants profess to move under Rule 12(b)(1) in arguing that the instruments were not securities. Defendants also moved to dismiss the securities claims under Rule 12(b)(6), arguing that the complaint does not state a claim upon which relief may be granted. The decision concerning the status of the instruments is properly resolved under Rule 12(b)(6), and defendants' motion will be treated as if raised under that Rule. *See Williamson v. Tucker*, 645 F.2d 404, 415-16 (5th Cir. 1981).

whether the allegations in plaintiff's complaint support a finding that the mortgage participations in this case were "notes" under the family resemblance test enunciated in *Reves*, 494 U.S. at 65, or "investment contracts" under the analysis developed in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

—

A. Are the Mortgage Investments "Notes"

Under the family resemblance test articulated by the Supreme Court in *Reves*, a note is presumed to be a security unless examination of the note with reference to four factors reveals a strong resemblance to an instrument recognized as a non-security interest. *Reves*, 494 U.S. at 65. If the note does not resemble a recognized non-security interest, the Court must determine, with reference to the same four factors, whether a new category of non-security instruments should be recognized. 494 U.S. at 67. The factors to be considered are:

> (1) the motivations that would prompt a reasonable buyer and seller to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectation of the investing public; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary.

Banco Espanol, 973 F.2d at 55 (citing *Reves*, 494 U.S. at 66-67). The Second Circuit in *Banco Espanol* determined that the loan participations in that case were not "securities" because they resembled loans issued by banks for commercial purposes. 973 F.2d at 55-56. That decision provides the framework for the Court's decision in the instant case.

Included in the enumerated categories of non-securities are notes secured by a mortgage on a home. The investments in this case were characterized as "'promissory notes' relating to buildings in New York City and other locations...[T]he investments were mortgages, primarily short-term bridge loans for construction and cooperative conversions." Amended Complaint ¶ 25. Although the mortgages in this case did not secure

individual homes, the Court agrees with the reasoning of the Court in *Singer v. Livoti*, which held that mortgages for properties other than homes sufficiently resemble mortgages on homes, an enumerated category of non-securities, thus justifying a presumption that the mortgages themselves were not securities. 741 F. Supp. 1040, 1049 (S.D.N.Y. 1990). The nature of the instruments is not significantly affected by the fact that the mortgages were sold to plaintiffs and other parties in brokered transactions:

> Traditionally, obtaining private conventional mortgage financing of real property has been a function of lawyers and other regulated professionals, including real estate brokers and mortgage brokers, who present mortgage lending opportunities to their clients.... Today, and since the beginning of the Republic, a substantial number of conventional mortgage loans are made by private individuals, largely through the aid of knowledgeable intermediaries such as lawyers and real estate or mortgage brokers.

Singer, 741 F. Supp. at 1049.

The first *Reves* factor requires the Court to consider the motivations of a reasonable buyer and seller entering into the transactions at issue. The complaint indicates that the loan proceeds were to be used for cooperative conversions and renovation of commercial space. The seller of the mortgage interests, Eagle Funding, earned a fee for servicing the mortgages. The buyers of the mortgages received interest on their investment at a fixed rate and apparently had no prospect for profits in excess of the interest paid. Thus, as in *Banco Espanol*, "[t]he 'receipt of interest is not directly tied to profitability in such a way as to make loan participations securities.'" 763 F. Supp. 36, 44 (quoting *McVay v. Western Plains Serv. Corp.*, 823 F.2d 1395, 1399 (10th Cir. 1987)), *aff'd*, 973 F.2d 51 (2d Cir. 1992), *petition for cert. filed* (Nov. 25, 1992). Further, the mortgages and participation certificates were personally guaranteed by the principals of Eagle Funding. Under these circumstances, the motivations of a reasonable buyer and seller would be, from the

purchaser's point of view, an opportunity to invest in what appeared to be a relatively safe investment, receiving interest in return, and, from the seller's point of view, an opportunity to sell the underlying mortgages, freeing up funds to engage in other loan transactions while earning fees for servicing the original mortgages. These motivations indicate a transaction that is commercial in nature and supports a finding that the mortgage interests were not securities.

In considering the second *Reves* factor in *Banco Espanol*, the Second Circuit agreed with the district court's finding that "the plan of distribution was 'a limited solicitation to sophisticated financial or commercial institutions and not to the general public.'" 973 F.2d at 51. The plaintiffs in this case, however, were not sophisticated institutional investors, but a group of physicians and their families – apparently passive and unsophisticated investors – seeking safe investment vehicles. Moreover, plaintiffs apparently relied upon Twiste and the Laidlaw defendants to evaluate the instruments, as they had superior access to information concerning the loans. *See Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263, 1268 (S.D.N.Y. 1978). Because the plan of distribution, as pleaded by plaintiffs, was relatively broad and encompassed unsophisticated investors, the second factor militates against a finding that the mortgage participations here are not securities.

The District Court in *Banco Espanol* determined that the third criterium favored a finding that the participations at issue were not securities because the participations were not available to the general public and could be purchased only by sophisticated investors and only after they read, negotiated, and executed a Master Participation Agreement. 763 F. Supp. at 43. The Court found that this Agreement would put a reasonable sophisticated investor on notice that the instruments were participations in loans and not investments in business enterprises. 763 F. Supp. at 43. In this case, plaintiffs allege that they were passive investors who relied on the defendants to manage their discretionary accounts. However, the investments provide for a fixed interest rate and were supported by the personal guarantees of the principals of Eagle Funding. Although there

are conflicting considerations under this factor, the Court finds under these facts that members of the investing public would reasonably expect that the instruments in this case were not securities.

In *Banco Espanol* the fourth factor favored a finding that the participations were not securities because the Office of the Comptroller had issued specific guidelines addressing the purchase and sale of loan participations by national banks. 973 F.2d at 51. Thus, the application of the securities laws was deemed unnecessary. 973 F.2d at 51. Here, collaterized mortgages are regulated by New York law. Moreover,

> Real property transaction[s] have always been regarded as essentially local in nature. It is hard to believe that Congress would have intended to sweep them into the statutory scheme for the regulation of securities transactions affecting interstate commerce merely by the words of Section 3(a) of the 1934 Act.

Singer, 741 F. Supp. at 1051. Application of the securities laws to these instruments is thus unnecessary and not justified under the *Reves* analysis.

Having review[ed] the four *Reves* factors, the Court finds that the mortgages and mortgage participations involved in this case are not "notes" within the meaning of section 3(a) of the 1934 Act and cannot be considered securities on this basis.

B. Are the Mortgage Investments "Investment Contracts"

Whether an investment device should be considered an "investment contract" within the meaning of section 3(a) of the 1934 Act is determined with reference to the test enunciated by the Supreme Court in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946):

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby

> a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.

328 U.S. at 298-99. Generally, the Court must determine whether the instruments more closely resemble a "commercial transaction" or an "investment." *Exchange Nat'l Bank*, 544 F.2d at 1138. Although the Second Circuit recognized in *Banco Espanol* that loan participations might in some case be considered securities, 973 F.2d at 56, apparently no circuit court has ever been presented with a case where loan participations were deemed to be securities. *See Banco Espanol*, 763 F. Supp. at 41 (listing cases).

Applying the facts of this case to the *Howey* standard, the Court has determined that the each instrument here was clearly a "contract, transaction or scheme" implicated by the *Howey* test. However, the investments involved in this action were not related to a "common enterprise," as plaintiffs did not receive an undivided interest in a pool of loans but rather purchased participations in individual, identified mortgages. Further, with regard to the requirement that profits be expected, plaintiffs here had no expectation that the value of their investments would increase as a result of capital appreciation. Their sole source of expected income from each participation was the repayment of the principal of the loan plus a fixed rate of interest. This Court agrees with other courts that have found that the "receipt of interest is not directly tied to profitability in such a way as to make loan participations securities." *McVay v. Western Plains Service Corp.*, 823 F.2d 1395, 1399 (10th Cir. 1987) (citations omitted); *accord Banco Espanol*, 763 F. Supp. at 44.

As to the requirement that the investor's benefit is derived solely from the efforts of others, this Court must again concur with the District Court in *Banco Espanol*, which logically determined that where the interest rate on a loan was fixed, the return did not fluctuate depending upon the efforts of the organization servicing the loan. 763 F. Supp. at 44. Thus, the investors' returns could not be said to derive solely from the efforts of Laidlaw, Eagle Funding, or any "third person."

Analysis under the *Howey* factors leads this Court to the ineluctable conclusion that the investments in mortgage participations in this case simply were not securities within the meaning of the securities laws. Accordingly, plaintiffs' first, second, and third causes of action, which arise under the securities laws, must be dismissed.

II. Dismissal of the RICO Counts

In two separate counts of the amended complaint, plaintiffs allege that Laidlaw equities was an enterprise within the meaning of RICO and that the Laidlaw defendants, Eagle Funding and Twiste were associated in fact as an enterprise as defined in 18 U.S.C. § 1961(4); that defendants conducted or participated in the conduct of the enterprise's affairs through a "pattern of racketeering activity," as defined in 18 U.S.C. § 1961(5); and that this "racketeering activity," as defined in 18 U.S.C. § 1961(1), consisted of numerous acts that are indictable under 18 U.S.C. § 1341 (mail fraud) and 18 U.S.C. § 1343 (wire fraud).

The federal mail fraud statute prohibits the use of the mails in furtherance of "any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises." 18 U.S.C. § 1341. "The essential elements of a mail fraud violation are (1) a scheme to defraud, (2) money or property, and (3) use of the mails to further the scheme." *United States v. Wallach*, 935 F.2d 445, 461 (2d Cir. 1991).[3] "There is no requirement that the victim of the fraud be deceived by the very document that satisfies the statute's mailing requirement; rather, the requirement is merely that the mailing be 'in furtherance of' the fraud." *United States v. Paccione*, 949 F.2d 1183, 1196 (2d Cir. 1991) (citation omitted). The

---

[3] In *McNally v. United States*, 483 U.S. 350 (1987), the Supreme Court held that the mail fraud statute does not reach schemes to defraud citizens of their intangible rights to honest and impartial government. Subsequently, however, Congress broadened the scope of the mail fraud statute by enacting 18 U.S.C. § 1346, which provides that "[f]or purposes of this chapter [18 U.S.C. § 1341-46], the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services."

federal wire fraud statute prohibits the transmission of communications by wire, radio or television in interstate or foreign commerce in furtherance of "any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises." 18 U.S.C. § 1343. Moreover, "[b]ecause the mail fraud and wire fraud statutes use the same relevant language, [the Second Circuit] analyze[s] them the same way." *United States v. Schwartz*, 924 F.2d 410, 416 (2d Cir. 1991). In its Amended Complaint, plaintiffs refer to numerous mail and wire communications allegedly made in furtherance of defendants' scheme or artifice to defraud the plaintiffs.

Plaintiffs allege that, based on the foregoing, defendants have violated 18 U.S.C. § 1962(c), and that because they have been injured in their business or property by reasons of defendants' violation of § 1962(c), they are entitled to pursue their civil RICO claims pursuant to 18 U.S.C. § 1964(c). Defendants argue that plaintiffs' civil RICO claims must be dismissed pursuant to Rule 9(b) for failure to plead fraud with particularity or, in the alternative, pursuant to Rule 12(b)(6) for failure to state a claim upon which relief may be granted. The Court will address each argument in turn.

A. Rule 9(b) Considerations

Defendants argue that the RICO claim must be dismissed, pursuant to Rule 9(b), for failure to plead fraud with particularity. Rule 9(b) provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." Fed. R. Civ. P. 9(b). "The purpose of Rule 9(b) is threefold — it is designed to provide a defendant with fair notice of a plaintiff's claim, to safeguard a defendant's reputation from improvident charges of wrongdoing, and to protect a defendant against the institution of a strike suit." *O'Brien v. Nat'l Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991); *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987). However, "[o]n a [Rule 9(b)] motion to dismiss, a court must read the complaint generously, and draw all inferences in favor

of the pleader." *Cosmas v. Hassett*, 886 F.2d 8, 11 (2d Cir. 1989); *see also O'Brien*, 936 F.2d at 676-77 (on a Rule 9(b) motion to dismiss, the Court "assume[s] the truth of plaintiffs' allegations").

Pursuant to Rule 9(b), "[t]he time, place, and nature of the misrepresentations must be set forth so that the defendant's intent to defraud, to employ any scheme or artifice to defraud, to make any untrue statement of a material fact, or to engage in any act or course of business that would operate as a fraud . . . is revealed." *Ross v. Bolton*, 904 F.2d 819, 823 (2d Cir. 1990); *see also DiVittorio*, 822 F.2d at 1247 ("fraud allegations ought to specify the time, place, speaker, and content of the alleged misrepresentations"). Further, where multiple defendants are alleged to have been involved in fraudulent activity, "the complaint should inform each defendant of the nature of his alleged participation in the fraud." *DiVittorio*, 822 F.2d at 1247. "Although scienter need not be alleged with great specificity, plaintiffs are still required to plead the factual basis which gives rise to a 'strong inference' of fraudulent intent." *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) (quoting *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988)). In addition,

> [d]espite the generally rigid requirement that fraud be pleaded with particularity, allegations may be based on information and belief when facts are peculiarly within the opposing party's knowledge. This exception to the general rule must not be mistaken for license to base claims of fraud on speculation and conclusory allegations. Where pleading is permitted on information and belief, a complaint must adduce specific facts supporting a strong inference of fraud or it will not satisfy even a relaxed pleading standard.

Id., 902 F.2d at 172 (citations omitted); *see also DiVittorio*, 822 F.2d at 1247-48.

In a civil RICO action in which the predicate acts alleged constitute mail or wire fraud, "[a]llegations of mail [or wire] fraud must be made with the particularity required by Federal

Rule of Civil Procedure 9(b)." *McLaughlin v. Anderson*, 962 F.2d 187, 191 (2d Cir. 1992). "Pursuant to this higher pleading standard, the 'complaint must adequately specify the statements it claims were false or misleading, give particulars as to the respect in which plaintiffs contend the statements were fraudulent, state when and where the statements were made, and identify those responsible for the statements.' " *Id.* (quoting *Cosmas*, 886 F.2d at 11). Additionally, the complaint must identify "the purpose of the mailing within the defendant's fraudulent scheme." *Id.* (quoting *Sun Sav. & Loan Ass'n v. Dierdorff*, 825 F.2d 187, 196 (9th Cir. 1987)). The complaint also must allege intentional fraud or reckless indifference to the truth; "Acts done inadvertently, mistakenly, or in good faith without an intent to defraud do not satisfy the requirements of the statute." *O'Malley v. New York City Transit Authority*, 896 F.2d 704, 706 (2d Cir. 1990).

Plaintiffs claim that the monthly account statements sent out by Laidlaw and Pershing and the written confirmations of specific trades furthered the fraudulent scheme. These letters were, however, routine business communications. *See O'Malley*, [896] F.2d at 707. Plaintiffs fail to connect the mailing of these reports to the fraudulent scheme, except in the most conclusory language. *See, e.g.*, Amended Complaint ¶ 79. Similarly, plaintiffs fail to connect any fraud perpetrated by Twiste or any other actor to the Laidlaw defendants by pleading facts giving rise to an inference that the Laidlaw defendants possessed the requisite fraudulent intent. Plaintiffs also allege generally that the sales of the mortgage investments constituted mail and wire fraud, but fail to provide a factual basis sufficient to support the conclusory allegations of intent to defraud made against the Laidlaw defendants. *See DeVaney v. Chester*, 813 F.2d 566, 568 (2d Cir. 1987). The complaint also alleges fraud against the Laidlaw defendants and Twiste collectively, thus failing to particularize the allegations to satisfy the requirement that "[w]here multiple defendants are asked to respond to allegations of fraud, the complaint should inform each defendant of the nature of his participation in the fraud." *Adler v. Berg Harmon Assoc.*, 790 F. Supp. 1222, 1227 (S.D.N.Y. 1992).

Finally, plaintiffs fail to specify those documents that contained fraudulent statements. Although plaintiffs argue accurately that a relaxed particularity requirement applies where facts are peculiarly within the opposing parties' knowledge, "[t]his exception to the general rule must not be mistaken for license to base claims of fraud on speculation and conclusory allegations." *Wexner*, 902 F.2d at 172. The Court rejects the suggestion that the statements and reports qualify as matters "peculiarly" within the defendants' knowledge, as these documents were all mailed to plaintiffs, according to the allegations of the complaint. However, even if these documents qualified for the exception permitting diminished particularity, they fail to allege specific facts supporting their conclusory allegations of fraud.

Plaintiffs' failure to plead the fraud elements of the RICO claims with particularity is fatal to the complaint in its present form. Although defendants suggest that plaintiffs should not be permitted a second chance to amend the complaint, the Court has determined that one further amendment of the complaint should be permitted pursuant to Rule 15(a) of the Federal Rules of Civil Procedure. *See Foman v. Davis*, 371 U.S. 178, 182 (1962); *Ronzani v. Sanofi S.A.*, 899 F.2d 195, 198 (2d Cir. 1990) (quoting 2A Moore & Lucase, Moore's Federal Practice ¶ 12.14 at 12-99 (2d ed. 1989) ("the usual practice is to grant leave to amend the complaint.")); *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986) ("Complaints dismissed under Rule 9(b) are 'almost always' dismissed with leave to amend"). Plaintiffs therefore shall be granted thirty days to file a second amended complaint.

B. Rule 12(b)(6) Considerations

The Court now turns to consider the sufficiency of the complaint under Fed. R. Civ. P. 12(b)(6). "The court's function on a Rule 12(b)(6) motion is not to weigh the evidence that might be presented at a trial but merely to determine whether the complaint itself is legally sufficient." *Festa v. Local 3, Int'l Bhd. of Electrical Workers*, 905 F.2d 35, 37 (2d Cir. 1990); *see also Ryder Energy Distrib. Corp. v. Merrill Lynch Commodities, Inc.*, 748 F.2d 774, 779 (2d Cir. 1984) ("The function of a motion

to dismiss 'is merely to assess the legal feasibility of the complaint, not to assay the weight of the evidence which might be offered in support thereof.' ") (quoting *Geisler v. Petrocelli*, 616 F.2d 636, 639 (2d Cir. 1980)).

A motion to dismiss must be denied "unless it appears beyond a doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974) (citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)); *see also Oliver Schools, Inc. v. Foley*, 930 F.2d 248, 252 (2d Cir. 1991). The Court must limit its analysis to the four corners of the complaint, but may consider documents incorporated into the complaint by reference. *Allen v. Westpoint-Pepperell, Inc.*, 945 F.2d 40, 44 (2d Cir. 1991). In addition, the Court must draw all reasonable inferences in favor of the plaiantiff. *Papasan v. Allain*, 478 U.S. 265, 283 (1986); *Allen*, 945 F.2d at 44; *Murray v. Milford*, 380 F.2d 468, 470 (2d Cir. 1967); *Hill v. Sullivan*, 125 F.R.D. 86, 90 (S.D.N.Y. 1989) ("[A]ll allegations in plaintiffs' amended complaint must be accepted as true and liberally construed.").

Plaintiffs do not allege that the Laidlaw defendants actively defrauded them. Rather, they seek to hold the Laidlaw defendants liable for the acts of Twiste, who was an employee, officer, and director of the Laidlaw defendants, pursuant to a theory of *respondeat superior*. The amended complaint alleges that Twiste received commissions from Eagle Funding for the mortgage participations purchased by the plaintiffs. There is no allegation that the Laidlaw defendants directly benefitted from the transactions involving the plaintiffs and Twiste or that Twiste sought to benefit the Laidlaw defendants in any way. Nor do plaintiffs allege that any employees, officers, or directors other than Twiste were involved in the alleged fraud.

Although the Second Circuit apparently has not had occasion to determine whether *respondeat superior* is an appropriate basis for civil liability under RICO, the weight of authority in this district and other circuits is against the imposition of such liability. *See, e.g., Qatar Nat'l Navigation & Trans. Co. v. Citibank, N.A.*, 1992 U.S. Dist. LEXIS 14,784, *17-20 (S.D.N.Y.

Sept. 29, 1992); *Kahn v. Chase Manhattan Bank, N.A.*, 760 F. Supp. 369, 373 (S.D.N.Y. 1991); *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1080 (S.D.N.Y. 1988) ("*Respondeat superior* has been rejected as a basis for liability under § 1962(c)."); *accord D & S Auto Parts, Inc. v. Schwartz*, 838 F.2d 964, 967 (7th Cir.) ("Imposing vicarious liability would defeat the purposes of RICO."), *cert. denied*, 486 U.S. 1061 (1988); *Schofield v. First Commodity Corp.*, 793 F.2d 28, 32 (1st Cir. 1986) ("we think the concept of vicarious liability is directly at odds with the Congressionally intent behind section 1962(c)."). This Court is compelled to concur with such convincing authority and therefore finds the independent acts of an employee or officer not acting in his employer's interest are not a sufficient basis to hold the employer liable under RICO.

"The bare minimum RICO charge is that a defendant personally committed or aided and abetted the commission of two predicate acts." *McLaughlin*, 962 F.2d at 192 (citing *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 237 (1989)). The amended complaint does not allege sufficiently the involvement of the Laidlaw defendants in the fraudulent scheme. Counts IV and V of the amended complaint thus fail to state a claim upon which relief may be granted and properly must be dismissed as against the Laidlaw defendants.[4]

Plaintiffs adequately plead the enterprise requirement for the RICO charges contained in Counts IV and V. Count IV sufficiently alleges that Laidlaw was a RICO enterprise. Count V alleges that the Laidlaw defendants, Eagle Funding, and Twiste associated together "for the common purpose of engaging in a scheme whereby they sold highly risky, speculative, oversubscribed and in some cases fictitious interests in mortgages to unsuspecting members of the public, including plaintiffs." *See* Amended Complaint ¶ 87. Defendants argue that the amended complaint is inadequate because plaintiffs have failed properly to allege that the enterprise is separate from the racketeering acts.

---

[4] The Court notes that Rule 9(b) of the Federal Rules of Civil Procedure also requires dismissal of the RICO claims against the Laidlaw defendants for failure to demonstrate an adequate connection between each defendant and the alleged fraud. *See DiVittorio*, 822 F.2d at 1248-49.

Although evidence tending to demonstrate that certain predicate acts were committed may also provide support for a finding that there was an association in fact, the "enterprise must be proven by evidence of an ongoing association that functions as a continuing unit and not merely by proof of the act of racketeering." *United States v. Turkette*, 452 U.S. 576, 583 (1981); *see also United States v. Indelicato*, 865 F.2d 1370, 1384 (2d Cir.) (en banc), *cert. denied*, 491 U.S. 907 (1989); *Elliott v. Foufas*, 867 F.2d 877, 881 (5th Cir. 1989); *United States v. Riccobene*, 709 F.2d 214, 223-24 (3d Cir.), *cert. denied*, 464 U.S. 849 (1983); *Zola v. Gordon*, 685 F. Supp. 354, 373 (S.D.N.Y. 1988). However, the enterprise element is pleaded properly if the association in fact is a continuing operation and the acts are related to a common purpose. *See Landy v. Mitchell Petroleum Technology Corp.*, 734 F. Supp. 608, 622 (S.D.N.Y. 1990) (citing *Indelicato*, 865 F.2d at 1376). In the instant case, the complaint alleges that the Laidlaw defendants, Eagle Funding, and Twiste were associated in fact in a continuing endeavor to defraud the plaintiffs and engaged in a pattern of continuing fraudulent activity in fraudulently effecting the sale of mortgages and mortgage participations to other investors. Thus, plaintiffs' pleading of the enterprise element of Count V is sufficient to withstand the instant motion to dismiss.

As noted, however, Counts IV and V of the amended complaint must be dismissed as against the Laidlaw defendants for failure to state a claim upon which relief may be granted, as the complaint does not sufficiently connect the Laidlaw defendants to the alleged fraud.

III. Supplemental Jurisdiction Over Plaintiffs' State Law Claims

Subject matter jurisdiction over this action is premised on the federal questions asserted in the counts of the complaint alleging violations of the securities laws and RICO. Plaintiffs additionally allege five claims sounding in state law: breach of fiduciary duty, conversion, fraud and deceit, negligent misrepresentation, and misrepresentation. As the securities and RICO claims have been dismissed, and the requirements for

diversity jurisdiction are not satisfied, there is no basis for the assertion of supplemental jurisdiction over plaintiffs' state law claims. "[I]n the usual case in which all federal-law claims are eliminated before trial, the balance of factors . . . will point toward declining to exercise jurisdiction over the remaining state law claims." *Carnegie-Mellon Univ. v. Cohill*, 484 U.S. 343, 350 n. 7 (1988); *accord United Mine Workers v. Gibbs*, 383 U.S. 715, 726 (1966); *Grondahl v. Merritt & Harris, Inc.*, 964 F.2d 1290, 1294 (2d Cir. 1992). Plaintiffs' state law claims therefore must be dismissed as against the Laidlaw defendants.

IV. Rule 11 Sanctions

The moving defendants seek the imposition of Rule 11 sanctions against the plaintiffs, arguing that the amended complaint was pleaded with insufficient specificity precisely because there was no colorable cause of action underlying the claims for relief. Rule 11 provides in part that:

> Every pleading, motion, and other paper of a party represented by an attorney shall be signed by at least one attorney of record in the attorney's individual name, whose address shall be stated. . . . The signature of an attorney or party constitutes a certificate by the signer that the signer has read the pleading, motion, or other paper; that to the best of the signer's knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation. . . . If a pleading, motion, or other paper is signed in violation of this rule, the court, upon motion or upon its own initiative, shall impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the reasonable expenses incurred because of the filing of the pleading, motion, or other paper, including a reasonable attorney's fee.

Fed. R. Civ. P. 11. The Supreme Court has noted that "the central purpose of Rule 11 is to deter baseless filings in the District Court and thus . . . streamline the administration and procedure of the federal courts." *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 393 (1990).

"Assuming the existence of identifiable, signed papers, a court must next determine whether those papers comply with Rule 11." *United States v. Int'l Bhd. of Teamsters*, 948 F.2d 1338, 1344 (2d Cir. 1991). A signed, filed paper violates Rule 11 if it is not "warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." Fed. R. Civ. P. 11. "In deciding whether the signer of a pleading, motion, or other paper has crossed the line between zealous advocacy and plain pettifoggery, the court applies an objective standard of reasonableness." *Id.*, 948 F.2d at 1344. In determining "the point at which an argument turns from merely 'losing' to losing *and* sanctionable," the Second Circuit has instructed the district court to "resolve all doubts in favor of the signer." *Motown Prod. Inc. v. Cacomm. Inc.*, 849 F.2d 781, 785 (2d Cir. 1988). The mandate to sanction, however, "is tempered by reminding judges to refrain from imposing sanctions where such action would " 'stifle the enthusiasm or chill the creativity that is the very lifeblood of the law.' " *Id.*, 849 F.2d at 785 (quoting *Eastway Constr. Corp. v. City of New York*, 762 F.2d 243, 254 (2d Cir. 1985)).

In the instant case, considering the factual setting of the transactions at issue and the current body of law interpreting the securities laws and RICO, the Court finds that plaintiffs have pursued their claims in good faith. Moreover, Rule 11 sanctions generally are deemed "inappropriate" where RICO claims are dismissed for failure to plead fraud with particularity but the plaintiff is granted leave to amend the complaint. *Official Pubs., Inc. v. Kable News Co.*, 884 F.2d 664, 670 (2d Cir. 1989). Although plaintiffs have not prevailed, the[ir] claims were clearly non-frivolous. Plaintiffs' reasoning with respect to each issue was grounded in existing law or reasonable arguments for extensions of existing law. Thus, no sanctions are warranted and defendants' motion for the imposition of sanctions pursuant to Rule 11 hereby is denied.

CONCLUSION

For the foregoing reasons, the motion of defendants Laidlaw Holdings, Inc., Laidlaw Equities, Inc., Laidlaw Holdings Asset Management, Inc., Gottfried von Meyern-Hohenberg, Michael F. Fahey, Jr., David N. Bottoms, Walter H. Bauer, and Hugh Regan to dismiss the amended complaint pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure hereby is granted and the amended complaint is dismissed in its entirety as to the moving defendants. Plaintiffs are granted leave to replead Counts IV and V of the complaint, arising under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(c), and those counts of the complaint arising under state law and falling within this Court's supplemental jurisdiction, within thirty (30) days. Defendants' motion for sanctions pursuant to Rule 11 of the Federal Rules of Civil Procedure is denied.

SO ORDERED

Dated: January 19, 1993
New York, New York

/s/ Peter K. Leisure
U.S.D.J.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK, and WILLIAM M. POLLACK TRUST,	:	OPINION AND ORDER
Plaintiffs,	:	90 Civ. 5788 (PKL)
— against —	:	
LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., WALTER L. TWISTE, GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUER and HUGH REGAN,	:	
Defendants.	:	

APPEARANCES

DAVIS, SCOTT, WEBER & EDWARDS
100 Park Avenue
New York, New York 10017
Steven M. Edwards, Esq., *of counsel*
Ellen Wahl Parker, Esq., *of counsel*

ATTORNEYS FOR PLAINTIFFS

RICHARD G. CUSHING, ESQ.
275 Madison Avenue, 12th Floor
New York, New York 10016

BODIAN & EAMES
575 Lexington Avenue, 31st Floor
New York, New York 10022
David T. Eames, Esq., *of counsel*

ATTORNEYS FOR DEFENDANTS

LEISURE, *District Judge*,

Plaintiffs brought this action to recover damages allegedly caused by certain fraudulent representations made by defendant Walter L. Twiste in connection with the acquisition and retention of certain investments by the plaintiffs.[1] Plaintiffs now move this Court for an Order certifying for appeal pursuant to 28 U.S.C. § 1292(b) the Opinion and Order of this Court dated January 19, 1993, which granted in part the defendants' motion to dismiss the complaint pursuant to Rule 12 and Rule 9 of the Federal Rules of Civil Procedure. Although the defendants do not join in plaintiffs' motion for certification, they do not oppose the motion and agree that "certification pursuant to 28 U.S.C. § 1292(b) is the most efficient way to proceed." *See* Memorandum in Support of Plaintiff's Motion of Law in Support of Certification of Order for Interlocutory Appeal Pursuant to 28 U.S.C. § 1292(b), at 1 n.1; Memorandum of Defendants in Response to Motion for Certification of Order for Interlocutory Appeal Pursuant to Section 1292(b). For the following reasons, plaintiffs' motion hereby is granted.

---

[1] This action was stayed as against defendant Twiste on or about May 7, 1991, when he filed for protection under Chapter 7 of the Bankruptcy Code. Twiste is the sole defendant that did not join in the omnibus motion to dismiss the complaint that is at issue here.

BACKGROUND

The defendants moved to dismiss the original complaint on or about November 16, 1990. Prior to decision on that motion, plaintiffs filed an amended complaint in July 1991. The amended complaint contained ten counts. Count I alleged violations of section 12(1) of the Securities Act of 1933 (the "1933 Act") against all defendants. Count II alleged violations of section 12(2) of the 1933 Act against all defendants. Count III alleged violations of section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") against all defendants. Count IV alleged that Laidlaw Holdings, Inc. ("Holdings"), Laidlaw Holdings Asset Management ("Laidlaw Asset Management"), and Twiste violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1962(c), and that Laidlaw Equities, Inc. ("Laidlaw") was the relevant RICO enterprise. Count V alleged that Laidlaw, Holdings, Laidlaw Asset Management, and Twiste violated RICO, 18 U.S.C. § 1962(c), and that the relevant enterprise consisted of an association in fact including the Laidlaw defendants and Eagle S.A. Funding Co. Counts VI, VII, VIII, IX, and X asserted causes of action arising under state law against the Laidlaw defendants and Twiste concerning: breach of fiduciary duty, conversion, fraud and deceit, negligent misrepresentation, and misrepresentation.

The moving defendants sought an order dismissing the amended complaint with prejudice pursuant to Rules 9(b), 12(b)(1), and 12(b)(6) of the Federal Rules of Civil Procedure. Plaintiffs' securities law claims were dismissed based upon the Court's determination that the mortgage investments at issue in this action, as pleaded in the complaint, were not "securities" within the meaning of the 1933 Act and the 1934 Act. Plaintiffs' RICO claims were dismissed pursuant to the Court's finding that RICO does not provide for *respondeat superior* liability. Plaintiffs were grnated leave to replead Counts IV and V of the complaint, arising under the RICO, 18 U.S.C § 1962(c), and those counts of the complaint arising under state law and falling within this Court's supplemental jurisdiction.

DISCUSSION

Section 1292(b) of Title 28, United States Code, provides that an interlocutory order of a district court may be certified for immediate appeal if the court is

> of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation.

28 U.S.C. § 1292(b). If the District Court certifies the order for immediate appeal, the Court of Appeals may, in its discretion, permit an appeal to be taken from that order. *Id.* The Second Circuit repeatedly has "urge[d] the district court to exercise great care in making § 1292(b) certification." *Westwood Pharmaceuticals, Inc. v. Nat'l Fuel Gas Dist. Corp.*, 964 F.2d 85, 89 (2d Cir. 1992); *see also Klinghoffer v. S.N.C. Achille Lauro*, 921 F.2d 21, 25 (2d Cir. 1990).

A. *Controlling Question of Law*

The Opinion and Order at issue clearly involved a controlling question of law with respect to the dismissal of plaintiffs' securities law claims. First, the securities claims were dismissed because the Court found, as a matter of law, that the investments at issue were not "securities" as defined in the 1933 Act and the 1934 Act. Thus, plaintiffs securities claims are wholly barred by this Court's determination. Further, plaintiffs will be precluded from arguing that the alleged securities law violations may be treated as predicate acts for the RICO counts. It therefore is clear that the Opinion presents a controlling question of law with respect to the securities law claims.

With respect to plaintiffs' RICO claims, however, the Court finds that the dismissal on the grounds that RICO does not provide for the imposition of vicarious liability does not involve a controlling question of law, as plaintiffs have moved to amend

the complaint to add a cause of action to pierce the corporate veil. If successful, this claim would permit the imposition of RICO liability directly upon the various defendants and thus would moot the Court's determination of this issue. Accordingly, the question of vicarious liability under RICO does not constitute a "controlling question of law" in this case that properly is certifiable pursuant to section 1292(b).

B. *Substantial Ground for Difference of Opinion*

The Court also finds that there is "substantial ground for difference of opinion" regarding the controlling question of law. The mere fact that a disputed issue is a question of first impression is insufficient to demonstrate a substantial ground for difference of opinion. *See, e.g., Drake v. Lochinvar Water Heaters, Inc.*, 618 F. Supp. 549, 554 (D. Minn. 1985), *rev'd on other grounds sub nom. Drake v. Honeywell, Inc.*, 797 F.2d 603 (8th Cir. 1986); *Federal Deposit Ins. Corp. v. First Nat'l Bank*, 604 F. Supp. 616, 622 (E.D. Wis. 1985); *Max Daetwyler Corp. v. Meyer*, 575 F. Supp. 280, 283 (E.D. Pa. 1983). Rather,

> [i]t is the duty of the district judge faced with a motion for certification to analyze the strength of the arguments in opposition to the challenged ruling when deciding whether the issue for appeal is truly one on which there is a *substantial* ground for dispute.

Max Daetwyler Corp., 575 F. Supp. at 283.

With respect to the Court's determination that the investments at issue in this action were not "securities," the Second Circuit has found that participations in mortgages may be considered securities despite the fact that the underlying instruments are not securities. *See Banco Espanol De Credito v. Sec. Pacific Nat'l Bank*, 973 F.2d 51, 56 (2d Cir. 1992), *cert. denied*, 1993 U.S. LEXIS 4254 (June 21, 1993). It appears, however, that no appellate court has ever been presented with a case in which loan participations were deemed to be securities. *See Banco Espanol De Credito v. Sec. Pacific Nat'l Bank*, 763 F. Supp. 36, 41 (S.D.N.Y. 1991) (listing cases), *aff'd*, 973 F.2d 51 (2d Cir. 1992),

cert. denied, 1993 U.S. LEXIS 4254 (June 21, 1993). Whether the mortgage participations purchased on behalf of the plaintiffs were securities is an issue that is on the fringe of the law in this developing area. Although this Court, having considered the factors of the family resemblance test, *see Reves v. Ernst & Young*, 494 U.S. 56, 66-67 (1975), and the definition of "investment contract," *see S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946), found that the mortgage participations described in the complaint were not securities, the Court recognizes that there is substantial ground for difference of opinion in this area of the law that has, as yet, undefined boundaries. *Cf. American Geophysical Union v. Texaco Inc.*, 802 F. Supp. 1, 29-30 (S.D.N.Y. 1992) (granting certification on issue because "the area of fair use is one which spawns enormous differences of opinion" and decision arguably was in tension with another court's decision in a similar case). Thus, plaintiffs have fulfilled the second requisite of certification under section 1292(b).

The Court finds, however, that plaintiffs have failed to demonstrate substantial ground for difference of opinion with respect to the availability of a vicarious liability theory under RICO. Plaintiffs have not satisfied the burden of showing "substantial doubt" that the Court's determination was correct by proffering authority suggesting that vicarious liability might properly be imposed. *See* S. Rep. No. 2434, 85th Cong., 2d Sess. (1958), *reprinted in* 1958 U.S.C.C.A.N. 5255, 5257 (legislative history of section 1292); *see also Shipping Corp. of India, Ltd. v. American Bureau of Shipping*, 752 F. Supp. 173, 175 (S.D.N.Y. 1990) (citations omitted); *see also Von Bulow v. Von Bulow*, 634 F. Supp. 1284, 1312 (S.D.N.Y. 1986) ("no 'substantial grounds for difference of opinion' since there is no conflicting authority on this narrow issue"). Thus, the question of vicarious liability under RICO is not certifiable under section 1292(b).

C. *Immediate Appeal Will Materially Advance the Ultimate Termination of the Litigation*

Finally, plaintiffs must demonstrate that immediate appeal of the Court's Opinion and Order will materially advance the ultimate termination of the litigation. The Court's decision with

respect to plaintiffs' securities law claims completely disposed of one of the theories upon which this action is based and may limit their ability to demonstrate violations of RICO. If certification of the Opinion was denied, a substantial duplication of effort might be required if, following a trial on the remaining claims, plaintiffs obtained a reversal of the Court's decision on appeal. This proceeding remains in its initial stages; much repetition of discovery and a retrial may be avoided by permitting interlocutory review of the Court's decision to obtain a final decision as to whether the securities claims in the complaint are viable. Therefore, in this case, the most efficient way to proceed is to permit the parties to seek immediate appellate review of the Opinion. Accordingly, it is the opinion of this Court that an immediate appeal will materially advance the ultimate termination of this litigation. *See Sea Pines of Virginia, Inc. v. PLD, Ltd.*, 399 F. Supp. 708, 712 (M.D. Fla. 1975) (granting certification following determination that a purchase money note was not a security).

D. ***Framing the Questions Presented for Review***

Although

> section 1292(b) authorizes certification of *orders* for interlocutory appeal, not certification of *questions*[,] . . . in certifying an order for interlocutory review it is helpful if the district judge frames the controlling question(s) the judge believes is presented by the order being certified. . . .

Isra Fruit Ltd. v. Agrexco Agricultural Export Co., 804 F.2d 24, 25 (2d Cir. 1986). Accordingly, the following controlling question is presented for review by the Court of Appeals:

> Do the mortgages and mortgage participations pleaded in plaintiffs' complaint constitute "securities" within the meaning of section 3(a)(10) of the Securities Exchange Act of 1934, 28 U.S.C. § 78c(a)(10)?

Plaintiff argues that the question of whether vicarious liability is available under RICO is a second question properly certifiable

pursuant to section 1292(b). Although the Court finds that this question does not merit certification, the Court of Appeals may wish to take the opportunity to address this question, as that Court's review is not limited to any particular questions but rather extends to the entire Opinion.

CONCLUSION

For the foregoing reasons, plaintiffs' motion for certification of the Opinion and Order of this Court, dated January 19, 1993, pursuant to section 1292(b) of Title 28, United States Code, hereby is granted. This action will be placed on the suspense calendar of the Court pending a determination by the Second Circuit as to whether an interlocutory appeal will be permitted and, if so permitted, resolution of the ensuing appeal. Further, plaintiffs' motion to amend the complaint pursuant to Rule 15(a) of the Federal Rules of Civil Procedure shall be held in abeyance pending the restoration of this case to the active calendar of the Court.

SO ORDERED

Dated: June 25, 1993
New York, New York

/s/ Peter K. Leisure
U.S.D.J.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK and WILLIAM M. POLLACK TRUST,	:	90 Civ. 5788 (PKL)
Plaintiffs,	:	AMENDED COMPLAINT
—versus—	:	Jury Trial Demanded
LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., WALTER L. TWISTE, GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUER and HUGH REGAN,	:	
Defendants.	:	

Plaintiffs, by their attorneys Davis, Markel & Edwards, for their amended complaint against defendants, state, on knowledge as to plaintiffs and otherwise on information and belief, as follows:

1. This action arises out of the fraudulent sale of mortgage investments by defendants to plaintiffs in violation of the Securities Act of 1933 ("the 1933 Act"), the Securities Exchange Act of 1934 ("the 1934 Act"), the Racketeer Influenced and Corrupt Organizations Act ("RICO") and common law, including the fiduciary duty defendants owed plaintiffs as brokers of discretionary investment accounts.

Jurisdiction and Venue

2. The jurisdiction of the Court is invoked pursuant to 28 U.S.C. § 1331; § 22 of the 1933 Act, 15 U.S.C. § 77v; § 27 of the 1934 Act, 15 U.S.C. § 78aa; 18 U.S.C. §§ 1962 and 1964; and the principles of pendent jurisdiction.

3. Venue in the Southern District of New York is proper because the claim arose in this judicial district (28 U.S.C. § 1391(a); 15 U.S.C. § 78aa); because the offer or sale of the securities involved herein took place in this district (15 U.S.C. § 77v); because defendants are found, are inhabitants or transact business in this district (15 U.S.C. §§ 77v, 78aa); because defendants are found, have an agent, or transact their affairs in this district (18 U.S.C. § 1965(a)); because defendants Laidlaw Holdings, Inc. and Laidlaw Equities, Inc. have their principal place of business in this judicial district (28 U.S.C. § 1391(b)); and because defendants Laidlaw Holdings, Inc. and Laidlaw Equities, Inc. have contacts with this district sufficient to subject them to personal jurisdiction if this district were a separate State (28 U.S.C. § 1391(c)).

The Parties

4. Plaintiff Dr. Stephen J. Pollack ("Dr. Pollack") is an orthopaedic surgeon residing in Staten Island, New York, and is a partner in an orthopaedic medicine practice called Staten Island Orthopaedics ("S.I. Orthopaedics").

5. Plaintiff Dr. Frank A. Ariosta ("Dr. Ariosta") is an orthopaedic surgeon residing in Staten Island, New York, and is a partner in S.I. Orthopaedics.

6. Plaintiffs S.I. Orthopaedics Target Plan ("Target Plan") and S.I. Orthopaedics Voluntary Plan ("Voluntary Plan"), are pension plans organized for the benefit of the partners and employees of S.I. Orthopaedics. Voluntary Plan is a subsidiary of Target Plan, representing the segregated pension contributions of Dr. Pollack. Drs. Pollack and Ariosta are the trustees of Target Plan and Voluntary Plan.

7. Plaintiff William M. Pollack Trust ("Pollack Trust") is a trust organized under the laws of the State of New York. Dr. Pollack and his sister are the sole beneficiaries of the Pollack Trust. Defendant Walter LeRoy Twiste is the trustee of the Pollack Trust.

8. Plaintiff Michael Pollack is the son of Dr. Stephen J. Pollack and resides in Staten Island, New York.

9. Defendant Laidlaw Holdings, Inc. ("Laidlaw Holdings") is a corporation organized and existing under the laws of the State of Delaware, with its principal place of business in the City, County and State of New York. Since at least January 1990, Laidlaw Holdings has owned and controlled between 75% and 100% of the stock of defendants Laidlaw Equities, Inc. and Laidlaw Holdings Asset Management, Inc. Since at least January 1990, Laidlaw Holdings has been a controlling person of defendant Laidlaw Equities, Inc. and Laidlaw Holdings Asset Management, Inc., within the meaning of Section 15 of the 1933 Act, 15 U.S.C. § 77o, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t.

10. Defendant Laidlaw Holdings Asset Management, Inc. ("Laidlaw Asset Management") is a corporation organized and existing under the laws of the State of Delaware, with its principal place of business in the City, County and State of New York. At all relevant times, Laidlaw Asset Management was an investment advisor registered with the SEC pursuant to § 203(c) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-3(c).

11. Defendant Laidlaw Equities, Inc. ("Laidlaw Equities") is a corporation organized and existing under the laws of the State of Delaware, with its principal place of business in the City, County and State of New York. Prior to 1990, Laidlaw Equities was called Laidlaw Holdings. In 1990, a new corporation was formed and given the name Laidlaw Holdings and the company that had been Laidlaw Holdings was renamed Laidlaw Equities. At all relevant times, Laidlaw Equities was a registered broker-dealer and a member of the NASD.

12. Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management are the successors in interest to Kuhns Bros. & Laidlaw, Inc., which, in turn, was the successor in interest to Laidlaw, Adams & Peck, Inc., Laidlaw Ansbacher Inc. and Laidlaw Coggeshall. Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management, by contract or by operation of law, have succeeded to the liabilities and obligations of their predecessor companies vis-a-vis the plaintiffs.

13. Defendant Walter LeRoy Twiste ("Twiste") was the President and Chief Executive Officer and a Director of Laidlaw Holdings from at least January 1990 until June 1990; he was the President and Chief Executive Officer and a Director of Laidlaw Equities from at least May 1988 until June 1990; and he was the Vice-Chairman of Laidlaw Asset Management from at least January 1990 until June 1990. As of February 6, 1990, Twiste indirectly owned between 10% and 25% of Laidlaw Holdings' shares and at all relevant times he was a controlling person of Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management within the meaning of Section 15 of the 1933 Act, 15 U.S.C. § 77o, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t. Twiste is, and at all relevant times has been, the trustee of the Pollack Trust.

14. Defendant Gottfried von Meyern-Hohenberg ("von Meyern-Hohenberg") is the Chairman of the Board of Laidlaw Holdings and is and has been the Chairman of the Board of Laidlaw Equities since May 1988. As of February 6, 1990, von Meyern-Hohenberg indirectly owned between 10% and 25% of Laidlaw Holdings' shares and at all relevant times he was a controlling person of Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management within the meaning of Section 15 of the 1933 Act, 15 U.S.C. § 77o, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t.

15. Defendant Michael Francis Fahey, Jr. ("Fahey") is an Officer and a Director of Laidlaw Holdings and is and has been Chief Financial Officer, Executive Vice President and a Director of Laidlaw Equities since May 1988. At all relevant times Fahey was a controlling person of Laidlaw Holdings, Laidlaw

Equities and Laidlaw Asset Management within the meaning of Section 15 of the 1933 Act, 15 U.S.C. § 77o, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t.

16. Defendant David Newton Bottoms, Jr. ("Bottoms") is Executive Vice President and a Director of Laidlaw Holdings, is and has been Senior Executive Vice President, Secretary and a Director of Laidlaw Equities since May 1988, and is President of Laidlaw Asset Management. As of February 6, 1990, Bottoms indirectly owned between 10% and 25% of Laidlaw Holdings' shares and at all relevant times he was a controlling person of Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management within the meaning of Section 15 of the 1933 Act, 15 U.S.C. § 77o, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t.

17. Defendant Walter Head Bauer ("Bauer") is an Officer and Director of Laidlaw Holdings and is and has been Senior Executive Vice President and a Director of Laidlaw Equities since May 1988. As of February 6, 1990, Bauer indirectly owned between 10% and 25% of Laidlaw Holdings' shares and at all relevant times he was a controlling person of Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management within the meaning of Section 15 of the 1933 Act, 15 U.S.C. § 77o, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t.

18. Defendant Hugh Regan ("Regan") is an Officer and Director of Laidlaw Holdings and is and has been Executive Vice President and a Director of Laidlaw Equities since May 1988. As of February 6, 1990, Regan indirectly owned between 5% and 10% of Laidlaw Holdings' shares and at all relevant times he was a controlling person of Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management within the meaning of Section 15 of the 1933 Act, 15 U.S.C. § 77o, and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t.

19. Defendants Laidlaw Holdings, Laidlaw Equities and Laidlaw Asset Management are collectively referred to herein as "the Laidlaw defendants." Defendants Twiste, von Meyern-Hohenberg, Fahey, Bottoms, Bauer and Regan are collectively referred to herein as "the individual defendants."

Factual Background

20. From 1970 to 1977, Twiste was affiliated with the securities firm of Trainor Wortham Co. Inc. ("Trainor Wortham"). In approximately 1970, Dr. Pollack entered into a relationship with Twiste whereby Twiste and Trainor Wortham acted as advisor and broker for Dr. Pollack's investment account. In approximately 1973, Dr. Ariosta entered into a similar relationship with Twiste and Trainor Wortham. Continuing through 1977, Drs. Pollack and Ariosta, their families and their pension plans utilized the services of Twiste and Trainor Wortham as advisor and broker for their investment accounts.

21. In 1977, Twiste became affiliated with the Laidlaw defendants. At that time, plaintiffs became clients of the Laidlaw defendants and Twiste managed their accounts. From 1977 through June 1990, plaintiffs have been clients of the Laidlaw defendants, and Twiste, most recently as president of Laidlaw Equities, has managed their accounts.

22. As of May 1990, plaintiffs maintained the following accounts with Laidlaw Equities, which were managed by Twiste:

Account Name	Account Number
S.I. Orthopaedic (Target)	7L5-814733
S.I. Orthopaedic (Voluntary)	7L5-814717
Stephen J. Pollack	7L5-814626
Stephen J. Pollack (IRA)	7L5-814667
William J. Pollack (Trust)	7L5-811374
William J. Pollack (Trust)	7L5-811978
Harriet Pollack (IRA)	7L5-814022
Michael E. Pollack	7L5-814659
Frank A. Ariosta (IRA)	7L5-104721
Frank A. Ariosta (Cust./Cynthia)	7L5-814311
Frank A. Ariosta (Cust./Leanne)	7L5-814303
Ann Ariosta	7L5-810020

The total value of these accounts as of May 25, 1990, as reported in statements furnished by Laidlaw Equities to plaintiffs, exceeded $ 3.5 million. Twiste, in his capacity as Vice-Chairman of Laidlaw Asset Management, selected investments for those accounts.

23. At all relevant times, plaintiffs received two types of periodic statements from the Laidlaw defendants and their agents with regard to activity in plaintiffs' accounts. The first was a computer printout, published monthly by Laidlaw Holdings, entitled "Portfolio Evaluation" and sometimes referred to as the "APL Report." The second was a computer printout published monthly by Pershing, a division of Donaldson, Lufkin & Jenrette, One Pershing Plaza, Jersey City, New Jersey 07399, which acted as clearing agent for Laidlaw Equities. That report was sometimes referred to as the "Pershing Statement." In addition, plaintiffs periodically received written confirmations of specific trading activities. All such statements were mailed to plaintiffs through the means and instrumentalities of the United States mail.

24. While plaintiffs' accounts with the Laidlaw defendants were discretionary investment accounts, at all relevant times plaintiffs instructed the Laidlaw defendants and Twiste to pursue only conservative, low-risk investments. For the most part, the funds in the accounts were invested in bonds and other debt instruments, as opposed to equities, in accordance with plaintiffs' instructions. On the few occasions on which plaintiffs became aware that the Laidlaw defendants and Twiste had departed from that investment strategy – for example, when the Laidlaw defendants and Twiste invested a small portion of plaintiffs' funds in "junk" bonds – plaintiffs informed the Laidlaw defendants and Twiste that such investments were inconsistent with their objectives and the funds were promptly reinvested in other securities consistent with plaintiffs' objectives.

The Mortgage Investments

25. In or about 1985, Dr. Pollack noticed that the Portfolio Evaluations included references to "promissory notes" relating

to buildings in New York City and other locations. Dr. Pollack immediately telephoned Twiste and questioned him about those investments. Twiste informed Dr. Pollack that the investments were mortgages, primarily short-term bridge loans for construction and cooperative conversions. Twiste stated that the mortgages were "sound, guaranteed and secured" and were consistent with plaintiffs' investment objectives. Twiste did not provide Dr. Pollack or plaintiffs with any further description or disclosure with regard to the investments, either orally or in writing. Plaintiffs accepted and relied on Twiste's representation that the mortgages were "sound, guaranteed and secured" and were consistent with their investment objectives.

26. At various times and in each of the years between 1985 and May 1990, Twiste continued to assure Drs. Ariosta and Pollack in face-to-face meetings and in frequent telephone conversations, in words or substance, that the mortgages were "sound, guaranteed and secured" and consistent with plaintiffs' investment objectives. Twiste also told Drs. Ariosta and Pollack that the mortgages were short term bridge loans with maturities of approximately one year. Based on their long relationship and their trust and confidence in the Laidlaw defendants and Twiste, plaintiffs relied on those representations.

27. Throughout the period 1985 through May of 1990, Twiste invested plaintiffs' funds in numerous mortgages for various properties. Those mortgages, and the income derived therefrom, were identified in the periodic Portfolio Evaluations sent to plaintiffs through the United States mail. According to those reports, the mortgages all had terms of three years or less. When a mortgage reached maturity, it was either retired, extended or renewed. According to the Portfolio Evaluations, the mortgages performed as represented by Twiste.

28. The Laidlaw defendants, and indirectly the individual defendants, benefitted from these mortgage investments by charging plaintiffs an investment management fee on the total size of their investment portfolio, which included the mortgage investments.

29. From time to time, income and proceeds from the mortgage investments were transferred by Laidlaw Equities to Pershing by means of interstate wire communication. Such amounts were then reported on the monthly Pershing Statements as a lump sum. The Pershing Statements did not identify particular mortgages to which such amounts related, thus making it difficult to use the Pershing Statements as a means of verifying the information contained in the Portfolio Evaluations provided directly by the Laidlaw defendants.

30. As of May 1, 1990, the total amount of plaintiffs' funds purported invested by the Laidlaw defendants and Twiste in the mortgages in question was as follows:

Account	Amount
Michael E. Pollack 7L5-814659	$18,924.00
Pollack Trust 7L5-811374	$205,000.00
Stephen J. Pollack 7L5-81426	$360,000.00
Target Plan 7L5-814733	$450,000.00
Voluntary Plan 7L5-84717	$60,000.00
	Total: $1,093,924.00

The individual mortgages, their original purchase dates and their maturity dates, to the extent known by plaintiffs, are identified in Exhibit A annexed hereto. At all relevant times, plaintiffs understood that they could liquidate their investment or, where appropriate, renew or extend their investment at the time of the maturity date set forth in the Portfolio Evaluations.

Discovery of The Fraudulent Scheme

31. On or about June 20, 1990, Dr. Pollack learned that Twiste was no longer employed by the Laidlaw defendants and that

he had checked into a mental institution. On June 21, Dr. Pollack and a representative went to the offices of the Laidlaw defendants to determine what had happened. Representatives of the Laidlaw defendants told them that Twiste had resigned from the firm and had committed "serious acts of fraud." Representatives of the Laidlaw defendants also told them that the Laidlaw defendants had discovered misappropriations, irregularities and improprieties in the accounts managed by Twiste. Representatives of the Laidlaw defendants stated that Twiste had stolen money from the accounts of certain clients, although they assured Dr. Pollack that no money had been stolen from plaintiffs' accounts.

32. At the June 21 meeting and thereafter, plaintiffs learned that the mortgage investments were actually the result of certain transactions between the Laidlaw defendants and Eagle S.A. Funding Company ("Eagle Funding"). Many of the mortgages were second mortgages and many had not been recorded. Some of the mortgages were fictitious, and in some instances the funds taken from plaintiffs' accounts ostensibly for investment in mortgages were not used for that purpose at all.

33. Contrary to the representations made by Twiste, the mortgage investments were not sound, were not guaranteed and were not secured. Nor were they short term bridge loans as represented by Twiste. Moreover, the mortgage investments were wholly inconsistent with plaintiffs' stated objective of making conservative, low risk investments. In addition, neither Twiste nor the Laidlaw defendants conducted any investigation of the mortgage investments to determine whether they were, in fact, "sound, guaranteed and secured" as represented by Twiste.

34. Eagle Funding and the Laidlaw defendants were engaged in a scheme whereby they sold highly risky, speculative, oversubscribed and in some cases fictitious interests in mortgages to unsuspecting members of the public, including plaintiffs. They misled those investors into believing the mortgages were performing by utilizing the funds of new investors to make interest and principal payments on prior investments, and by issuing false and misleading Portfolio Evaluations and making false and

misleading oral statements. Twiste received commissions on those investments from Eagle Funding, which he did not disclose to plaintiffs.

35. Eagle Funding ceased making interest and principal payments on the mortgage investments in May 1989. The Laidlaw defendants and Twiste hid this fact from plaintiffs by falsifying the entries in the Portfolio Evaluations that were periodically sent to plaintiffs. Plaintiffs did not discover that fact, notwithstanding their due diligence, until June 1990.

36. Prior to June 1990, the Laidlaw defendants and Twiste fraudulently concealed the misrepresentations and omissions complained of herein by falsifying the entries in the Portfolio Evaluations as described above and continuing to represent that the mortgage investments were sound, guaranteed and secured and consistent with plaintiffs' investment objectives as described above. The individual defendants other than Twiste are responsible for that fraudulent concealment by virtue of their failure to create, implement and maintain adequate internal controls and by virtue of their failure to exercise adequate supervision and control over Twiste.

37. In or about May 1990, Avi Weinberg, one of the partners of Eagle Funding, committed suicide. On or about May 10, 1990, Eagle Funding filed a voluntary petition for bankruptcy under Chapter 11 of title 11, United States Code. None of these events, which were known to the Laidlaw defendants, was disclosed to plaintiffs in a timely fashion.

38. As a result of the foregoing events, plaintiffs' mortgage investments are substantially worthless.

39. Plaintiffs sought the Laidlaw defendants' assistance and help in recovering their mortgage investments. The Laidlaw defendants repeatedly urged plaintiffs not to file suit while they devised a means to resolve their problems. Notwithstanding those representations, which caused plaintiffs to refrain from taking action, no resolution was forthcoming. Moreover, the Laidlaw defendants, after an initial period of cooperation, refused to

provide plaintiffs with information plaintiffs requested concerning their accounts, threatened to cease representing plaintiffs' interests in the Eagle Funding bankruptcy proceeding if plaintiffs commenced litigation, and ultimately refused to continue representing plaintiffs' interests in the Eagle Funding bankruptcy proceeding when this lawsuit was commenced.

40. On or about May 2, 1991, the SEC commenced an action against Twiste for aiding and abetting violations of the securities laws by Laidlaw Equities and Laidlaw Asset Management. Among other things, the complaint in that action alleged that Laidlaw Equities and Laidlaw Asset Management had employed schemes or artifices to defraud clients; had failed to maintain sufficient net capital legally to transact a general securities business; had filed inaccurate reports with the NASD; had failed to make and keep current certain books and records with respect to the firm's business affairs and activity in customer accounts as required by SEC rules, including an accurate general ledger, accurate ledger accounts for each customer, a memorandum of each brokerage order and of other instructions given or received for the purchase or sale of securities and an accurate record of the proof of money balances of all ledger accounts; and had failed to maintain copies of falsified Portfolio Evaluations sent to customers. On or about May 30, 1991, the SEC commenced an administrative proceeding against Twiste, Laidlaw Equities and Laidlaw Asset Management and made findings that Laidlaw Equities and Laidlaw Asset Management had misappropriated funds from investors, breached their fiduciary duties to investors, attempted to conceal defalcations and failed to maintain adequate internal controls, among other things. Shortly thereafter, Twiste, Laidlaw Equities and Laidlaw Asset Management consented to remedial sanctions that barred Twiste from association with any broker, dealer, investment advisor, investment company or municipal securities dealer and required the Laidlaw defendants to implement effective internal controls.

The Mortgage Investments are "Securities"

41. The mortgage investments in which defendants invested plaintiffs' funds were "notes," and thus securities, within the

meaning of § 2(1) of the 1933 Act, 15 U.S.C. § 77b, and § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) in that:

(a) The purpose of selling the mortgage investments (to the extent they were not fraudulent, fictitious and/or oversubscribed) was to finance substantial investments, and/or to raise money for the general use of a business enterprise. Plaintiffs and others purchased the mortgage investments primarily because of the profit they expected the mortgage investments to generate.

(b) The mortgage investments were sold to a broad segment of the public.

(c) It would have been reasonable for an investor to regard the mortgage investments as an "investment" had their risky, speculative nature been disclosed.

(d) This case presents no risk-reducing factor rendering application of the federal securities laws unnecessary. Plaintiffs were not protected by any alternative, comprehensive federal regulatory scheme; nor were the mortgage investments collateralized or insured.

(e) All of most of the mortgage investments were for a term of more than nine months.

42. The mortgage investments in which defendants invested plaintiffs' funds were "investment contracts," and thus securities, within the meaning of § 2(1) of the 1933 Act, 15 U.S.C. § 77b, and § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) for the following reasons:

(a) Those who invested in the mortgage investments, including plaintiffs, pooled their funds for the common purpose of becoming joint participants in particular mortgage investments, and their success as investors was tied to the overall success of each investment.

(b) Plaintiffs were led to expect profits from the mortgage investments and they risked the loss of the funds invested.

(c) Plaintiffs relied solely on the skill and efforts of others to produce the return they expected from their investments.

(d) Plaintiffs were passive and unsophisticated investors who relied on the Laidlaw defendants and Twiste to manage their discretionary accounts.

Relationships Among Defendants

43. The Laidlaw defendants and Twiste acted as agents of Eagle Funding in selling and offering to sell the mortgage investments to plaintiffs. Among other things, they had the power and authority to sell the mortgage investments to plaintiffs and they received compensation for doing so. Alternatively, under the 1933 Act, the Laidlaw defendants and Twiste were joint "issuers," with Eagle Funding, of the mortgage investments because they controlled or dominated Eagle Funding and caused it to issue the mortgage investments to the public. By virtue of these relationships, the Laidlaw defendants and Twiste were sellers and offerors of securities and were in privity with the plaintiffs.

44. At all relevant times up to the present, Laidlaw Holdings and each of the individual defendants had the power to and did exercise control over Laidlaw Equities and Laidlaw Asset Management through their stock holdings in Laidlaw Holdings and/or positions as corporate officers and directors of all of the Laidlaw defendants in that:

(a) the individual defendants comprised the management of and had primary operational responsibility for the management of the Laidlaw defendants;

(b) the individual defendants were responsible, both in law and in fact, for creation and maintenance of internal controls within the Laidlaw defendants;

(c) the individual defendants were responsible, both in law and in fact, for supervision of employees of the Laidlaw defendants, including Twiste;

(d) the individual defendants were responsible for ensuring that employees – particularly those exercising responsibility over discretionary accounts – operated in compliance with the law and fulfilled their fiduciary responsibilities to their clients.

Thus, the individual defendants and Laidlaw Holdings were, and are, controlling persons of Laidlaw Equities and Laidlaw Asset Management within the meaning of Section 15 of the 1993 Act, 15 U.S.C. § 77*o* and Section 20(a) of the 1934 Act, 15 U.S.C. § 78t.

45. The defendants other than Twiste failed to supervise or negligently supervised Twiste in his activities, and they failed to maintain and enforce a reasonable and proper system of supervision and internal control over his activities. Therefore, they cannot avail themselves of the defense that they acted in good faith with respect to the complained of violations of the securities laws.

Use of the Means and Instrumentalities of Interstate Commerce or Mails

46. Defendants sold and offered to sell the mortgage securities by the means and instrumentalities of interstate commerce or of the mails, as follows:

(a) Portfolio Evaluations were mailed to plaintiffs on or about the last day of each month from at least 1985 to the present;

(b) Pershing Statements were mailed to plaintiffs on or about the 25th day of each month from at least 1985 to the present;

(c) telephone conversations between Twiste and Dr. Pollack occurred on a frequent basis from at least 1985 to May 1990;

(d) income and proceeds from the mortgage securities were transferred by Laidlaw Equities to Pershing by means of interstate wire communication periodically from at least 1985 to May 1990;

(e) the mortgage securities were offered or sold to persons within the State of New York and outside of the State of New York.

Demand Upon Trustee

47. The foregoing facts demonstrate that it would have been futile for plaintiff Dr. Pollack, as beneficiary of the Pollack Trust, to attempt to persuade Twiste, as trustee of that trust, to bring this action. Accordingly, demand upon Twiste is excused.

COUNT I

Against All Defendants

(Sale of Unregistered Securities in Violation of §§ 5(a), 5(c) and 12(1) of the 1933 Act, 15 U.S.C. §§ 77e(a), 77e(c) and 771(1))

48. Plaintiffs repeat and reallege the allegations of ¶¶ 1-47 as if fully set forth herein.

49. Defendants sold and offered to sell securities by using funds in plaintiffs' discretionary investment accounts to purchase mortgage investments. Defendants sold and offered such securities in interstate commerce and used the means or instruments of transportation or communication in interstate commerce and the mails to send plaintiffs the Portfolio Evaluations and Pershing Statements and to make other written and oral representations to plaintiffs in connection with the sale of the securities. Defendants did not file a registration statement as to the securities and/or failed to ensure that a registraton statement was filed for the securites prior to their sale. At no time was a registration statement in effect as to the mortgage investments, which were securities.

50. By reason of the foregoing, defendants violated §§ 5(a), 5(c) and 12(1) of the 1933 Act.

51. As a direct and proximate result of these violations of the 1933 Act, plaintiffs have suffered monetary losses, in an amount as yet undetermined, but not less than $ 1,093,924.00, plus interest income which defendants falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

52. Defendants fraudulently concealed their failure to register the mortgage investments in compliance with § 12(1) of the 1933 Act and/or their failure to ensure that the mortgage investments were registered by their continued investment of plaintiffs' funds in the mortgage investments while repeatedly misrepresenting to Plaintiffs that the mortgage investments were sound, guaranteed, secured and consistent with the Plaintiffs' investment objectives, that the mortgage investments were short-term and easily transferable, and that the mortgage investments were performing as promised. Pursuant to § 13 of the 1933 Act, 15 U.S.C. § 77m, plaintiffs have brought this cause of action within one year after their discovery of the violations upon which it is based and not more than three years after the securities were bona fide offered to the public.

53. Plaintiffs hereby tender their securities (*i.e.*, the mortgage investments) to defendants.

COUNT II

Against All Defendants

(Misrepresentations and Omissions in Violation of § 12(2) of the 1933 Act, 15 U.S.C. § 771(2))

54. Plaintiffs repeat and reallege the allegations of ¶¶ 1-53 as if fully set forth herein.

55. Defendants sold and offered to sell the securities by means of prospectuses and oral communications.

(a) The Portfolio Evaluations defendants sent to plaintiffs reporting on the status of their discretionary investment accounts and mortgage investments, and other written documents confirming particular trades, were "notice[s], . . . letter[s], or communication[s] . . . confirm[ing] the sale of [a] security," and thus were "prospectuses" within the meaning of § 2(10) of the 1933 Act, 15 U.S.C. § 77b(10) ("the prospectuses").

(b) Twiste's telephone conversations with Dr. Pollack and his face-to-face meetings with Drs. Pollack and Ariosta were oral communications within the meaning of § 12(2) of the 1933 Act, 15 U.S.C. § 771(2) ("the oral communications").

56. The prospectuses included the following untrue statements of material facts:

(a) that the mortgage investments were "mortgages" when in fact they were, at best, uncollateralized, speculative participations in mortgages, many of which were unrecorded second mortgages;

(b) that plaintiffs' accounts were being invested in "mortgages," when in fact some of the mortgage investments were fictitious and/or oversubscribed; and

(c) that the mortgages continued to pay interest after May 1989, when in fact they did not.

57. The oral communications contained the following untrue statements of material facts:

(a) that the mortgage investments were "sound, guaranteed and secured";

(b) that the mortgage investments were short term bridge loans; and

(c) that the mortgage investments were suitable in view of plaintiffs' stated objective of making only conservative, low risk investments.

58. The prospectuses and oral communications omitted to state the following facts necessary in order to make the statements contained therein not misleading in the light of the circumstances under which they were made:

(a) that the mortgage investments were highly risky, speculative, oversubscribed and in some cases fictitious;

(b) that after May 1989, Laidlaw Equities and Twiste utilized the funds of new investors to make interest and principal payments on prior investments, in order to disguise the fact that the mortgage investments were non-performing;

(c) that after May 1989, Laidlaw Equities and Twiste falsified entries in the Portfolio Evaluations that were periodically sent to plaintiffs in order to disguise the fact that the mortgage investments were non-performing; and

(d) that some of the funds taken from plaintiffs' accounts ostensibly for investment in mortgages were not actually used for that purpose at all.

59. Plaintiffs did not know of the untruths or omissions contained in the prospectuses and the oral communications they received from the Laidlaw defendants and Twiste.

60. The untruths or omissions contained in the prospectuses and the oral communications were material. There is a substantial likelihood that, under all the circumstances, the facts omitted from the prospectuses and the oral communications would have assumed significance in the deliberations of a reasonable investor, or that the facts omitted from the prospectuses and the oral communications would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available with respect to the mortgage investments.

61. By reason of the foregoing, defendants violated § 12(2) of the 1933 Act.

62. As a direct and proximate result of these violations of the 1933 Act, plaintiffs have suffered monetary losses, in an amount as yet undetermined, but not less than $ 1,093,924.00, plus interest income which defendants falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

63. Pursuant to § 13 of the 1933 Act, 15 U.S.C. § 77m, plaintiffs have brought this action within one year after the discovery of the untrue statements or omissions, or after discovery should have been made by the exercise of reasonable diligence, and not more than three years after an investment decision was made.

64. Plaintiffs hereby tender their securities (*i.e.*, the mortgage investments) to defendants.

COUNT III

Against All Defendants

(Securities Fraud in Violation of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 Promulgated Thereunder)

65. Plaintiffs repeat and reallege the allegations of ¶¶ 1-64 as if fully set forth herein.

66. Defendants knew, or recklessly failed to know, that the statements they made in connection with the sale of the securities in the prospectuses and the oral communications (described in ¶¶ 54-58, above) contained untrue statements of material fact and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances, not misleading.

67. Defendants' scheme to sell plaintiffs fictitious and/or oversubscribed mortgage investments was a device, scheme or artifice to defraud in connection with the sale of securities.

68. Defendants' scheme to sell plaintiffs fictitious and/or oversubscribed mortgage investments was an act, practice, or course

of business which operated as a fraud or deceit upon plaintiffs in connection with the sale of securities.

69. Plaintiffs relied upon the untrue statements of material fact contained in the prospectuses and the oral communications.

70. Defendants' untrue statements of material fact and material omissions were a significant contributing cause of plaintiffs' purchase of the securities.

71. By reason of the foregoing, defendants violated § 10(b) of the 1934 Act, and SEC Rule 10b-5 promulgated thereunder.

72. As the direct and proximate result of defendants' violations of § 10(b) of the 1934 Act and SEC Rule 10b-5 promulgated thereunder, plaintiffs have suffered monetary losses, in an amount as yet undertermined, but not less than $ 1,093,924.00, plus interest income which defendants falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

COUNT IV

Against Laidlaw Holdings, Laidlaw Asset Management and Twiste

(Violation of Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(c))

73. Plaintiffs repeat and reallege the allegations of ¶¶ 1-72 as if fully set forth herein.

74. Laidlaw Equities is an "enterprise" within the meaning of 18 U.S.C. § 1961(4) in that it is a corporation. Laidlaw Equities is engaged in, or its activities affect, interstate or foreign commerce.

75. At all relevant times, Twiste was associated with Laidlaw Equities as an officer, director or employee. At all relevant times,

Twiste acted in furtherance of the Laidlaw defendants' business and his actions – even though illegal – benefitted the Laidlaw defendants.

76. Laidlaw Holdings is associated with Laidlaw Equities in that it is the parent corporation of Laidlaw Equities, and Laidlaw Asset Management is associated with Laidlaw Equities in that it is an affiliate of Laidlaw Equities.

77. Repeatedly during the period from 1985 through May 1990, Twiste, Laidlaw Holdings and Laidlaw Asset Management caused Laidlaw Equities to sell plaintiffs the mortgage investments.

78. Each sale of a mortgage investment to one of the plaintiffs constituted an act of "Racketeering Activity" within the meaning of 18 U.S.C. § 1961(1), in that each such sale was accomplished by means which constituted fraud in the sale of securities in violation of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) and SEC Rule 10b-5 promulgated thereunder, as set forth in Count III, above, and also constituted an indictable violation of 18 U.S.C. § 1341 (mail fraud) and of 18 U.S.C. § 1343 (wire fraud).

79. Each sale of a mortgage investment constituted mail fraud in that

> (a) Twiste, Laidlaw Holdings and Laidlaw Asset Management devised or intended to devise a scheme or artifice to defaud plaintiffs and others by selling them fictitious and/or oversubscribed mortgage investments, and by selling them mortgage investments which were unsuitable for their known investment objectives;
>
> (b) Twiste, Laidlaw Holdings and Laidlaw Asset Management devised or intended to devise a scheme or artifice for obtaining money or property by means of false or fraudulent pretenses, representations or promises that the mortgage investments were suitable

investments and were not fictitious and/or oversubscribed;

(c) Twiste, Laidlaw Holdings and Laidlaw Asset Management devised or intended to devise a scheme or artifice to sell, dispose of, distribute, supply, or furnish counterfeit obligations or securities, or other articles, or things represented to be or intimated or held out to be such counterfeit or spurious articles, namely, the fictitious or oversubscribed mortgage investments;

(d) for the purpose of executing such schemes or artifices or attempting to do so, Twiste, Laidlaw Holdings and Laidlaw Asset Management placed the matter described in ¶ 46, above, in the post office or authorized depository to be sent or delivered by the Postal Service, or took or received said matter therefrom, or knowingly caused said matter to be delivered by mail according to the direction thereon, or at the place at which it was directed to be delivered by the person to whom it was addressed.

80. Each sale of a mortgage investment constituted wire fraud in that

(a) Twiste, Laidlaw Holdings and Laidlaw Asset Management devised or intended to devise a scheme or artifice to defraud plaintiffs and others by selling them fictitious and/or oversubscribed mortgage investments, and by selling them mortgage investments which were unsuitable for their investment objectives;

(b) Twiste, Laidlaw Holdings and Laidlaw Asset Management devised or intended to devise a scheme or artifice for obtaining money or property by means of false or fraudulent pretenses, representations or promises that the mortgage investments were suitable investments and were not fictitious or oversubscribed;

(c) For the purpose of executing such schemes or artifices or attempting to do so, Twiste, Laidlaw

Holdings and Laidlaw Asset Management transmitted or caused to be transmitted by means of wire in interstate or foreign commerce the writings, signs, signals and sounds described at ¶ 46, above.

81. Twiste, Laidlaw Holdings and Laidlaw Asset Management caused other customers of Laidlaw Equities to invest in mortgage investments similar to those offered and sold to plaintiffs by the same or similar means which constituted acts of "Racketeering Activity" as defined in 18 U.S.C. § 1961.

82. In connection with their scheme to defraud plaintiffs, Twiste, Laidlaw Holdings and Laidlaw Asset Management committed additional acts of "Racketeering Activity" within the meaning of 18 U.S.C. § 1961(1) by stealing money from plaintiffs' discretionary investment accounts in an amount exceeding $5,000 and transmitting or transferring that money in interstate commerce in violation of 18 U.S.C. § 2314.

83. The predicate acts described above constitute a pattern of racketeering activity because they are related and occurred over a substantial period of time (*i.e.*, more than three years), ending in May 1990. The predicate acts are related because they have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events, in that

(a) the predicate acts had the common purpose of defrauding plaintiffs and other Laidlaw Equities customers of money;

(b) the predicate acts had the common result of defrauding the plaintiffs and other Laidlaw Equities customers of money;

(c) each of the predicate acts was committed by Twiste, Laidlaw Holdings and Laidlaw Asset Management among others;

(d) plaintiffs were among the victims of each predicate act;

(e) the predicate acts were committed by the same or similar methods, *i.e.*, through the use of Portfolio Evaluations and oral communications containing material untruths and omissions;

(f) the predicate acts were interrelated by distinguishing characteristics and were not isolated events because they were all part of an overall scheme of inducing plaintiffs and other Laidlaw Equities customers to invest in fictitious and/or oversubscribed mortgage investments, or of inducing plaintiffs and other Laidlaw Equities customers to invest in mortgage investments which were unsuitable for their investment objectives.

84. By reason of the foregoing, Twiste, Laidlaw Holdings and Laidlaw Asset Management violated RICO, 18 U.S.C. § 1962(c).

85. This pattern of racketeering activity injured plaintiffs in their business or property within the meaning of 18 U.S.C. § 1964(c).

COUNT V

Against the Laidlaw Defendants and Twiste

(Violation of Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(c))

86. Plaintiffs repeat and reallege the allegations of ¶¶ 1-85 as if fully set forth herein.

87. The Laidlaw defendants and Eagle Funding were an "enterprise" within the meaning of 18 U.S.C. § 1961(4) in that they comprised a group of individuals associated in fact which functioned as a continuing unit for the common purpose of engaging in a scheme whereby they sold highly risky, speculative, oversubscribed and in some cases fictitious interests in mortgages to unsuspecting members of the public, including plaintiffs.

88. Laidlaw Holdings was associated with the assocation-in-fact in that it was, and is, the parent corporation of Laidlaw

Equities and Laidlaw Asset Management, which are members of the association-in-fact.

89. Laidlaw Equities and Laidlaw Asset Management were associated with the association-in-fact in that they were members of the association-in-fact.

90. At all relevant times, Twiste was employed by and associated with the association-in-fact in that he was employed by the Laidlaw defendants, a member of the association-in-fact, and acted on behalf of and as the agent of the association-in-fact in selling and offering to sell the mortgage investments to plaintiffs and other investors.

91. The Laidlaw defendants and Twiste conducted or participated in the acts of Racketeering Activity set forth in ¶¶ 77-82, above. The Laidlaw defendants and Twiste conducted or participated in the conduct of the association-in-fact through the pattern of racketeering activity set forth in ¶ 83, above.

92. By reason of the foregoing, the Laidlaw defendants and Twiste violated RICO, 18 U.S.C. § 1962(c).

93. The pattern of racketeering activity injured plaintiffs in their business or property within the meaning of 18 U.S.C. § 1964(c).

COUNT VI

Against the Laidlaw Defendants and Twiste

(Breach of Fiduciary Duty)

94. Plaintiffs repeat and reallege the allegations of ¶¶ 1-93 as if fully set forth herein.

95. As brokers managing plaintiffs' discretionary accounts, the Laidlaw defendants and Twiste at all relevant times owed plaintiffs the highest fiduciary obligation to do all within their power to protect plaintiffs' accounts. At all relevant times, the

Laidlaw defendants and Twiste also were under fiduciary obligations, *inter alia*, to: conduct themselves in conformity with plaintiffs' stated investment objectives; truthfully disclose all material facts with regard to investments made on plaintiffs' behalf; truthfully disclose any interest they had in any transactions and avoid making secret profits on any transactions; refrain from making fictitious investments; account for all transactions to plaintiffs and exercise the highest degree of honesty and candor toward plaintiffs.

96. At all relevant times, plaintiffs had the right to rely and did rely upon the assumption that the Laidlaw defendants and Twiste were acting for their benefit and fulfilling all their fiduciary obligations.

97. At all relevant times, the Laidlaw defendants and Twiste assured plaintiffs that they were complying with their fiduciary obligations.

98. The Laidlaw defendants and Twiste violated their fiduciary obligations by engaging in a scheme whereby they sold highly risky, speculative, oversubscribed and in some cases fictitious interests in mortgages to unsuspecting members of the public, including plaintiffs, and misled those investors into believing the mortgages were performing by utilizing the funds of new investors to make interest and principal payments on prior investments, and by issuing false and misleading Portfolio Evaluations and making false and misleading oral statements.

99. By reason of the foregoing, the Laidlaw defendants and Twiste violated the fiduciary obligations they owed plaintiffs as brokers of discretionary investment accounts.

100. As the direct and proximate result of these breaches of fiduciary obligations, plaintiffs have suffered monetary losses, in an amount as yet undetermined, but not less than $1,093,924.00, plus interest income which defendants falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

COUNT VII

Against the Laidlaw Defendants and Twiste

(Conversion)

101. Plaintiffs repeat and reallege the allegations of ¶¶ 1-100 as if fully set forth herein.

102. Plaintiffs entrusted their funds to the Laidlaw defendants and Twiste with the express business purpose of permitting defendants to invest the funds exclusively in conservative, low-risk investments, including the mortgage investments.

103. The Laidlaw defendants and Twiste obtained possession of plaintiffs' funds by falsely representing that the funds would be invested in sound, secured and guaranteed investments.

104. The Laidlaw defendants and Twiste had a legal duty to preserve and return the funds deposited in the discretionary accounts.

105. The Laidlaw defendants and Twiste did not preserve or return the funds, but rather, wrongfully exerted dominion over them in denial of, or inconsistent with, plaintiffs' rights therein.

106. The Laidlaw defendants and Twiste used plaintiffs' funds in an unauthorized manner and in violation of plaintiffs' clear instructions by investing them in unsafe, risky, speculative mortage investments, and in fictitious and/or oversubscribed mortgage investments.

107. As the direct and proximate result of these acts of conversion, plaintiffs have suffered monetary losses, in an amount as yet undetermined, but not less than $1,093,924.00, plus interest income which defendants falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

108. By reason of the foregoing, defendants are liable to plaintiffs under New York common law for the tort of conversion.

COUNT VIII

Against the Laidlaw Defendants and Twiste

(Fraud and Deceit)

109. Plaintiffs repeat and reallege the allegations of ¶¶ 1-108 as if fully set forth herein.

110. The Laidlaw defendants and Twiste knowingly or recklessly made untrue representations of fact to plaintiffs with the intention that plaintiffs would be deceived by and act upon those representations.

111. Plaintiffs acted upon the representations of the Laidlaw defendants and Twiste, permitting the Laidlaw defendants and Twiste to continue to exercise control over the funds in the discretionary accounts, and permitting additional funds to be deposited in those accounts.

112. As the direct and proximate result of the fraudulent and deceitful conduct, plaintiffs have suffered monetary losses, in an amount as yet undetermined, but not less than $1,093,924.00, plus interest income which the Laidlaw defendants and Twiste falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

113. By reason of the foregoing, the Laidlaw defendants and Twiste are liable to plaintiffs under New York common law for the tort of fraud and deceit.

114. At all relevant times, the Laidlaw defendants and Twiste were systematically engaged in a morally culpable course of conduct, aimed at the public generally. Therefore, they are liable for punitive as well as compensatory damages.

COUNT IX

Against the Laidlaw Defendants and Twiste

(Negligent Misrepresentation)

115. Plaintiffs repeat and reallege the allegations of ¶¶ 1-114 as if fully set forth herein.

116. The Laidlaw defendants and Twiste were careless in imparting words directly to plaintiffs upon which plaintiffs were expected to rely and upon which they acted, or failed to act, to their damage.

117. At all relevant times, the Laidlaw defendants and Twiste were bound by a relation of duty to use care in communicating with plaintiffs if they communicated with them at all.

118. The Laidlaw defendants and Twiste knew that plaintiffs would rely on the Portfolio Evaluations and oral communications in deciding whether or not to invest additional money in the discretionary accounts and in deciding whether or not to continue the broker-client relationship between the Laidlaw defendants and Twiste on the one hand and plaintiffs on the other. Twistes' conduct, including his frequent reassurances that the investments were sound, secured and guaranteed, linked him and the Laidlaw defendants to the plaintiffs and evinced his understanding that plaintiffs would so rely.

119. Plaintiffs did in fact rely on the Portfolio Evaluations and oral communications in deciding whether or not to invest additional money in the discretionary accounts and in deciding whether or not to continue the broker-client relationship.

120. As the direct and proximate result of the negligent misrepresentations, plaintiffs have suffered monetary losses, in an amount as yet undetermined, but not less than $1,093,924.00, plus interest income which defendants falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

121. By reason of the foregoing, the Laidlaw defendants and Twiste are liable to plaintiffs under New York common law for the tort of negligent misrepresentation.

COUNT X

Against the Laidlaw Defendants and Twiste

(Misrepresentation)

122. Plaintiffs repeat and reallege the allegations of ¶¶ 1-121 as if fully set forth herein.

123. The Laidlaw defendants and Twiste made false material representations to plaintiffs.

124. Plaintiffs relied on the false material representations to their detriment. As the direct and proximate result of the false material representations, plaintiffs have suffered monetary losses, in an amount as yet undetermined, but not less than $1,093,924.00, plus interest income which defendants falsely claimed plaintiffs earned on the mortgage investments, and any commissions paid to defendants.

125. By reason of the foregoing, the Laidlaw defendants and Twiste are liable to plaintiffs under New York law for the tort of common law misrepresentation, and plaintiffs are entitled to the remedies of rescission and restitution.

126. Plaintiffs hereby tender their mortgage investments to defendants.

PRAYER FOR RELIEF

WHEREFORE, plaintiffs pray for judgment in their favor and against defendants as follows:

(a) awarding plaintiffs all damages sustained as a result of defendants' conduct, in an amount as yet undetermined but not less than $1,093,924.00;

(b) in the alternative, awarding plaintiffs the remedy of rescission with respect to all purchases of mortgage investments, including the return of the $1,093,924.00 purchase price, along with all other damages and relief need to restore plaintiffs to the position they held before any of their funds were invested in the mortgage investments;

(c) awarding plaintiffs interest income which defendants falsely claimed plaintiffs earned on the mortgage investments and any commissions paid to defendants;

(d) awarding plaintiffs punitive damages of $10,000,000;

(e) on Counts IV and V, awarding plaintiffs threefold damages and the cost of suit, including reasonable attorneys' fees, pursuant to 18 U.S.C. § 1964(c);

(f) awarding plaintiffs interest and costs of suit; and

(g) awarding plaintiffs such other and further relief as the Court deems just and proper.

September 7, 1990
June 28, 1991

DAVIS, MARKEL & EDWARDS

/s/Steven M. Edwards

Steven M. Edwards
Attorney # SE-2773
100 Park Avenue
New York, New York 10017
(212) 685-8000

Of Counsel:

Vincent Moccio
Lynne E. Johnston
Steven A. Hirsch

EXHIBIT A

Account Name

Staten Island Target Benefit Plan

Description	Amount	Orig. Purchase Date	Earliest Known Due Date	Latest Due Date
64 Alabama Ave.	25,000	12/5/86	12/4/87	12/4/90
375 Ocean Ave.	50,000	4/1/86	4/1/87	4/1/91
309 E. 108th St.	50,000	4/23/86	4/23/87	12/31/90
50-30 Realty Corp.	25,000	4/27/87	4/26/88	4/26/90
161 Madison Ave.	50,000	5/11/87	5/10/88	5/10/90
Riverdale Mtg	25,000	8/18/86	8/17/87	4/26/90
40 W. 45th St.	50,000	5/27/86	9/28/87	9/28/90
30 E. 21st St.	20,000	11/5/86	11/5/87	11/5/90
40 W. 45th St.	25,000	7/2/87	N/A	5/22/90
40 W. 45th St.	25,000	7/2/86	N/A	5/22/90
Canterbury Mtg.	50,000	10/2/90	N/A	6/30/90
Regency Estates	55,000	1/18/88	4/31/89	4/31/90

Staten Island Orthopaedic Group Retirement Voluntary Plan

Description	Amount	Orig. Purchase Date	Earliest Known Due Date	Latest Due Date
40 W. 45th St.	15,000	7/2/87	5/22/89	5/22/90
50-30 Realty Corp.	15,000	4/27/87	4/26/89	4/26/90
16-70 59th St.	15,000	6/12/86	6/12/89	6/12/90
309 E. 108th St.	15,000	4/23/86	12/31/89	12/31/90

Stephen J. Pollack

Description	Amount	Orig. Purchase Date	Earliest Known Due Date	Latest Due Date
375 Ocean Ave.	50,000	4/1/86	4/1/89	4/1/91
18 East 18th	25,000	1/18/88	4/8/89	4/9/91
50-30 Realty Corp.	35,000	9/1/87	4/26/89	4/26/90
161 Madison Ave.	50,000	5/11/87	5/10/89	5/10/90
40 W. 45th St.	25,000	7/2/87	5/22/89	5/22/90
306 E. 105th	50,000	6/10/87	6/15/89	6/15/90
2 E. 72nd St.	25,000	8/5/86	8/4/89	8/4/90
Riverdale Mtg.	25,000	8/18/86	8/17/89	8/17/90
40 West 45th St.	25,000	5/27/86	9/28/89	9/28/90
238 E. 49th	25,000	11/26/85	11/25/89	11/25/90
64 Alabama Ave.	25,000	12/4/87	12/4/89	12/4/90

William M. Pollack

Description	Amount	Orig. Purchase Date	Earliest Known Due Date	Latest Due Date
40 W. 45th St.	50,000	7/2/87	N/A	5/22/90
306 E. 105th St.	25,000	6/10/87	N/A	6/15/90
13 Keltz/144 Nottingham Dr.	30,000	7/22/87	N/A	7/22/90
Riverdale Mtg.	50,000	7/22/87	N/A	8/17/90
Smith Farm	50,000	2/27/87	N/A	3/2/91

Michael E. Pollack

Description	Amount	Orig. Purchase Date	Earliest Known Due Date	Latest Due Date
Riverdale Mtg.	10,000	8/18/86	N/A	8/17/90
Smith Farm Mtg.	8,924	2/27/87	N/A	3/2/91

Supreme Court, U.S.
FILED
OCT 11 1994
OFFICE OF THE CLERK

No. 94-433

In The

Supreme Court of the United States

October Term, 1994

LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUR and HUGH REGAN,

Petitioners,

vs.

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK and WILLIAM M. POLLACK TRUST,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

BRIEF IN OPPOSITION

STEVEN M. EDWARDS
DAVIS, SCOTT, WEBER & EDWARDS, P.C.
100 Park Avenue
New York, New York 10017
(212) 685-8000

Attorneys for Respondents

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

BEST AVAILABLE COPY

18 pp

QUESTION PRESENTED

Whether the Court of Appeals for the Second Circuit erred in holding that investments in mortgage participations sold by a securities broker to unsophisticated investors were securities within the meaning of the federal securities laws?

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

STATEMENT OF THE CASE 1

SUMMARY OF ARGUMENT 5

REASONS FOR DENYING THE WRIT 5

1. This Case Is Not Certworthy 5

2. The Second Circuit Did Not Misapply The *Reves* Factors 6

3. The Second Circuit's Holding Does Not Conflict With A Decision Of The Tenth Circuit ... 8

4. The Second Circuit's Holding Does Not Conflict With This Court's Holding In *Santa Fe* ... 9

5. The Second Circuit Did Not Misapply The Fourth *Reves* Factor 10

CONCLUSION 12

TABLE OF AUTHORITIES

Page

CASES

Banco Espanol de Credito v. Security Pac. Nat'l Bank, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 113 S.Ct. 2992 (1993) 9

Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020 (2d Cir. 1993) 7

Costello v. Oppenheimer & Co., 711 F.2d 1361 (7th Cir. 1983) 8

Craighead v. E.F. Hutton & Co., 899 F.2d 485 (6th Cir. 1990) 7

Exchange National Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) 6

Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985) 7

Hotmar v. Lowell H. Listrom & Co., 808 F.2d 1384 (10th Cir. 1987) 8

M & B Contracting Corp. v. Dale, 795 F.2d 531 (6th Cir. 1986) 8

Marine Bank v. Weaver, 455 U.S. 551 (1982) 7

Mechigian v. Art Capital Corp., 639 F. Supp. 702 (S.D.N.Y. 1986) 10

Melton v. Unterreiner, 436 F. Supp. 740 (E.D. Mo. 1977), *aff'd in relevant part*, 575 F.2d 204 (8th Cir. 1978) 6

Mercer v. Jaffe, Snider, Reitt & Heuer, P.C., 736 F. Supp. 764 (W.D. Mich. 1990), *aff'd without opinion*, 931 F.2d 893 (6th Cir. 1991) 6

Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980) 8

TABLE OF AUTHORITIES – Continued

Page

Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981) 8

Newburger, Loeb & Co. v. Gross, 563 F.2d 1057 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978) 8

O'Connor v. R.F. Lafferty & Co., Inc., 965 F.2d 893 (10th Cir. 1992) 7

Olson v. E.F. Hutton & Co., 957 F.2d 622 (8th Cir. 1992) 7

Pinter v. Dahl, 486 U.S. 622 (1988) 8

Resolution Trust Corp. v. Stone, 998 F.2d 1534 (10th Cir. 1993) 8, 9

Reves v. Ernst & Young, 494 U.S. 56 (1990) 4, 5, 6, 10

S.E.C. v. R.G. Reynolds Enterprises, Inc., 952 F.2d 1125 (9th Cir. 1991) 6

Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) 9

Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983) 8

Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1 (1st Cir. 1983) 7, 8

United States v. Farris, 614 F.2d 634 (9th Cir. 1979), *cert. denied*, 447 U.S. 926 (1980) 6

Wright v. Downs, No. 91-2050, 1992 U.S. App. LEXIS 17384 (6th Cir. July 17, 1992) 6

Zolfaghari v. Sheikholeslami, 943 F.2d 451 (4th Cir. 1991) 6

TABLE OF AUTHORITIES – Continued

Page

STATUTES

15 U.S.C. § 77e(a) 3
15 U.S.C. § 77b 4
15 U.S.C. § 77e(c) 3
15 U.S.C. § 77l(1) 3
15 U.S.C. § 77o 2
15 U.S.C. § 78c(a)(10) 4
15 U.S.C. § 78j(b) 8
15 U.S.C. § 78t 2
15 U.S.C. § 80b-1, *et seq.* 10
18 U.S.C. § 1292(b) 4
29 U.S.C. § 1001, *et seq.* 10

ADMINISTRATIVE RULES

SEC Rule 10b, 17 C.F.R. § 240.10b 3

No. 94-433

In The

Supreme Court of the United States

October Term, 1994

LAIDLAW HOLDINGS, INC., LAIDLAW EQUITIES, INC., LAIDLAW HOLDINGS ASSET MANAGEMENT, INC., GOTTFRIED VON MEYERN-HOHENBERG, MICHAEL F. FAHEY, JR., DAVID N. BOTTOMS, WALTER H. BAUR and HUGH REGAN,

Petitioners,

vs.

STEPHEN J. POLLACK, FRANK A. ARIOSTA, S.I. ORTHOPAEDICS TARGET PLAN, S.I. ORTHOPAEDICS VOLUNTARY PLAN, MICHAEL POLLACK and WILLIAM M. POLLACK TRUST,

Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

BRIEF IN OPPOSITION

STATEMENT OF THE CASE

The petition seeks review of a decision by the Second Circuit reversing a decision of the United States District Court for the Southern District of New York, which

granted a motion dismissing plaintiffs' amended complaint.[1] As alleged in the amended complaint, which must be taken as true for purposes of a motion to dismiss, plaintiffs are passive and unsophisticated investors who entrusted their money to the Laidlaw defendants. App. D-2-3, ¶¶ 4-8; D-6-7, ¶¶ 20-24; D-14, ¶ 42(d). The Laidlaw defendants include Laidlaw Asset Management, a registered investment advisor which managed plaintiffs' discretionary accounts; Laidlaw Equities, a registered broker-dealer which bought and sold securities for those accounts; Laidlaw Holdings, which owned Laidlaw Asset Management and Laidlaw Equities; and the officers and directors of the three corporate defendants, who are named as defendants under a controlling persons theory pursuant to section 15 of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. § 77o, and section 20(a) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78t. App. D-3-5, ¶¶ 9-19; D-14-15, ¶ 44. At all relevant times, plaintiffs' discretionary accounts were managed by Walter L. Twiste ("Twiste"),[2] who was president, chief executive officer and a director of Laidlaw Holdings and Laidlaw

---

[1] As used herein, the term "plaintiffs" refers to respondents Stephen J. Pollack, Frank A. Ariosta, S.I. Orthopaedics Target Plan, S.I. Orthopaedics Voluntary Plan, Michael Pollack and William M. Pollack Trust. The term "Laidlaw defendants" refers to Laidlaw Holdings, Inc., Laidlaw Equities, Inc., Laidlaw Holdings Asset Management, Inc., Gottfried von Meyern-Hohenberg, Michael F. Fahey, Jr., David N. Bottoms, Walter H. Baur and Hugh Regan. Laidlaw Holdings, Inc. is referred to as "Laidlaw Holdings"; Laidlaw Equities, Inc. is referred to as "Laidlaw Equities"; and Laidlaw Holdings Asset Management, Inc. is referred to as "Laidlaw Asset Management".

[2] Twiste, who is named as a defendant in the amended complaint, is not a party to the petition.

Equities, and vice-chairman of Laidlaw Asset Management. App. D-4, ¶ 13.

For more than eight years, in accordance with plaintiffs' instructions, Twiste invested plaintiffs' funds in conservative, low-risk investments such as bonds and other debt instruments which would normally be considered securities. App. D-7, ¶ 24. Beginning in approximately 1985, Twiste began to invest a portion of plaintiffs' funds in "promissory notes", with terms of one to three years, which he described as mortgage investments that were "sound, guaranteed and secured" and consistent with plaintiffs' investment objectives. App. D-7-8, ¶¶ 25-26. In June 1990, plaintiffs learned that Twiste had left the Laidlaw companies and had been admitted to a mental institution; he had stolen money from various clients' accounts; and the mortgage investments were not sound, guaranteed and secured as represented by Twiste, but were participations in mortgages that were unsecured, unrecorded, uncollateralized and, in some cases, oversubscribed and fictitious. App. D-9-11, ¶¶ 31-34; D-18, ¶ 56.[3]

In their amended complaint, plaintiffs asserted violations of the securities laws[4] and the Racketeer Influenced

---

[3] In May 1991, the Securities and Exchange Commission ("SEC") commenced proceedings against Twiste and Laidlaw, alleging fraud and failure to maintain adequate internal controls, which resulted in remedial sanctions, App. A-4 n.1; D-12, ¶ 40.

[4] Plaintiffs alleged violations of sections 5(a), 5(c) and 12(1) of the 1933 Act, 15 U.S.C. §§ 77e(a), 77e(c) and 77l(1) (Count I); § 12(2) of the 1933 Act (Count II); and § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (Count

and Corrupt Organizations Act ("RICO"), as well as various common law claims. Plaintiffs specifically alleged that the investments in the mortgage participations at issue were "notes" and "investment contracts" under the securities laws, § 2(1) of the 1933 Act, 15 U.S.C. § 77b and § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10). App. D-12-14, ¶¶ 41-42.[5] In granting the Laidlaw defendants' motion to dismiss, the district court ruled that there was no set of facts plaintiffs could prove that would enable them to demonstrate that the investments in mortgage participations were notes or investment contracts. App. B-4-11. The district court certified the issue under 28 U.S.C. § 1292(b), and the Second Circuit held on appeal that the mortgage participations alleged in the amended complaint were notes under the "family resemblance" test enunciated in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), without reaching any of the other issues raised. App. A-6-7, 8, 14.[6]

---

[5] The amended complaint specifically alleged that the investments had each of the characteristics identified by this Court in the applicable case law that would make them "notes" and "investment contracts". *Id.*

[6] Plaintiffs urged the Second Circuit to hold that the transactions at issue were investment contracts, but the court declined to decide that issue in view of its holding that the mortgage participations were notes. App. A-8 n.5. Plaintiffs also asked the Second Circuit to review the district court's decision that there is no corporate liability under RICO, but the court declined to consider that issue because the district court had not certified it and plaintiffs had been granted leave to replead. App. A-6 n.2.

SUMMARY OF ARGUMENT

This case is not certworthy because petitioners simply argue that the Second Circuit "misapplied" the *Reves* standards in connection with a motion to dismiss. Moreover, the Second Circuit did not misapply the *Reves* standards; it held that investments in mortgage participations sold to unsophisticated investors are "notes" under the securities laws. To the extent that petitioners argue that the securities broker and investment advisor who defrauded plaintiffs should be viewed as the "proper purchaser" here, and the securities laws should not apply because that securities broker and investment advisor was "sophisticated", their argument should be rejected because it would relieve brokers and investment advisors of liability for fraud under the securities laws. There is no conflict between the Second Circuit's decision and any decision of this Court or any other court, and the Second Circuit was correct in its judgment that there is no alternative regulatory scheme that would adequately protect plaintiffs in this case.

REASONS FOR DENYING THE WRIT

1. This Case Is Not Certworthy.

The essence of petitioners' argument is that "the Court of Appeals misapplied the factors adopted by this Court in *Reves*." Petition at 9. As petitioners' articulation of their own argument demonstrates, this case presents no novel questions of law, no disagreements between the circuits and no conflict with the governing precedent of

this Court. The parties agree that *Reves* is the applicable precedent, and the principles enunciated in *Reves* are clear; petitioners' claim is that *Reves* was "misapplied". Moreover, petitioners' claim is that *Reves* was misapplied in connection with a motion to dismiss. Thus, this case does not raise important questions of law, and petitioners will have ample opportunity to seek review of the very questions they raise here if they lose on the merits.

2. The Second Circuit Did Not Misapply The *Reves* Factors.

Petitioners claim that "[p]rior to the decision below, the cases overwhelming [*sic*] held that participations in commercial loans were not securities". Petition at 10 n.2. That is simply inaccurate. Courts throughout the country have consistently held that investments in loans are securities when they are sold as investments to unsophisticated investors. *Wright v. Downs*, No. 91-2050, 1992 U.S. App. LEXIS 17384, at *10 (6th Cir. July 17, 1992); *S.E.C. v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1131 (9th Cir. 1991); *Zolfaghari v. Sheikholeslami*, 943 F.2d 451, 455 (4th Cir. 1991); *United States v. Farris*, 614 F.2d 634, 641 (9th Cir. 1979), *cert. denied*, 447 U.S. 926 (1980); *Mercer v. Jaffe, Snider, Reitt & Heuer, P.C.*, 736 F. Supp. 764, 769-70 (W.D. Mich. 1990), *aff'd without opinion*, 931 F.2d 893 (6th Cir. 1991); *Melton v. Unterreiner*, 436 F. Supp. 740, 742 (E.D. Mo. 1977), *aff'd in relevant part*, 575 F.2d 204 (8th Cir. 1978). *See Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir. 1976) (promissory notes sold as

investments are securities even where the investor is sophisticated).[7]

To overcome this obstacle, petitioners make the argument (which they barely mentioned in the court below) that the Second Circuit failed to focus on the proper purchaser. They contend that Twiste – not plaintiffs – was the purchaser of the mortgage investments, and, as a "professional money manager", he was quite sophisticated and did not need the protection of the securities laws. Petition at 10-11. If this argument is accepted, many transactions involving fraud by securities brokers in the management of discretionary accounts would be removed from the protection of the securities laws.

There are many reasons why this argument is untenable. First, the securities laws were designed to deter fraud on the part of brokers and investment advisors, as well as issuers; there are legions of cases holding brokers and investment advisors liable for violating the securities laws.[8] Second, petitioners' argument ignores the fact that

---

[7] The cases make clear that it is not necessarily the instrument itself, but the way it is sold, that gives rise to the protections of the securities laws. *Compare Marine Bank v. Weaver*, 455 U.S. 551 (1982) (certificates of deposit are not securities) *with Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985) (certificates of deposit are securities).

[8] *E.g., Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993) (defining "suitability" claim); *O'Connor v. R.F. Lafferty & Co., Inc.*, 965 F.2d 893, 897-99 (10th Cir. 1992) (same); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493-94 (6th Cir. 1990) (same); *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 5 (1st Cir. 1983) (same); *see also Olson v. E.F. Hutton & Co.*, 957 F.2d 622,

the amended complaint alleges that Twiste and the Laidlaw corporate defendants were sellers or agents of the sellers. App. D-10, ¶ 34; D-14, ¶ 43.[9] Third, even if Twiste and the Laidlaw corporate defendants are considered agents of the purchasers, the securities laws prohibit fraud "in connection with" the purchase or sale of securities and therefore apply to agents of purchasers as well as agents of sellers. 15 U.S.C. § 78j(b).

3. The Second Circuit's Holding Does Not Conflict With A Decision Of The Tenth Circuit.

Petitioners contend that the Second Circuit's holding conflicts with the Tenth Circuit's decision in *Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993), where the court held that the purchase of automobile loans by a savings and loan did not involve the sale of a security. That case is readily distinguishable from this one because

---

628 (8th Cir. 1992) (defining "churning" claim); *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384, 1385-86 (10th Cir. 1987) (same); *M & B Contracting Corp. v. Dale*, 795 F.2d 531, 533 (6th Cir. 1986) (same); *Tiernan*, 719 F.2d at 5 (same); *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1367-68 (7th Cir. 1983) (same); *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416-17 (11th Cir. 1983) (same); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981) (same); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 820-21 (9th Cir. 1980) (same); *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1069 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978) (same).

[9] *See Pinter v. Dahl*, 486 U.S. 622, 647 (1988) (extending liability as a "seller" under § 12(1) of the 1933 Act to "those who solicit securities purchases" if "motivated at least in part by a desire to serve [their] own financial interests").

it involved the sale of commercial paper to a sophisticated bank in a transaction that is not normally perceived as an investment in securities.[10]

The Second Circuit recognized this distinction when it distinguished the instant case, involving the sale of investments to unsophisticated purchasers, from its own decision in *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 55-56 (2d Cir. 1992), *cert. denied*, 113 S.Ct. 2992 (1993), which involved the sale of participations in commercial loans by sophisticated banks to sophisticated banks. App. A-11.

4. The Second Circuit's Holding Does Not Conflict With This Court's Holding In *Santa Fe*.

Petitioners argue that the Second Circuit's decision conflicts with this Court's decision in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), where the Court held that not all breaches of fiduciary duty give rise to an action for securities fraud. Petition at 12-13. The Court did not hold that all breaches of fiduciary duty resulting from the commission of fraud fall outside the ambit of the securities laws. Where, as here, a broker and investment advisor managing a discretionary account commits fraud in the sale of an investment to an unsophisticated investor, the attendant breach of fiduciary duty argues in favor of the applicability of the securities laws, not against it.

---

[10] In an effort to make this case sound like *Stone*, petitioners repeatedly describe the transactions at issue as "commercial" mortgages. Petition at i, 5, 6, 11. That word does not appear in the amended complaint.

5. The Second Circuit Did Not Misapply The Fourth *Reves* Factor.

Petitioners argue that this Court should review the Second Circuit's decision because they disagree with that court's assessment of the extent to which there are alternative regulatory schemes rendering application of the securities laws unnecessary. Petition at 13-15.

Petitioners argue, first, that the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1, *et seq.* ("IAA"), provides adequate protection. This overlooks the fact that the IAA applies only to one defendant; it limits any recovery to the amount of the management fee; and it was designed to complement, rather than substitute for, the securities laws – a point made by the Second Circuit but totally ignored in the petition. App. A-14. Furthermore, the IAA does not even apply unless the investment is a security. *See, e.g., Mechigian v. Art Capital Corp.*, 639 F. Supp. 702, 705-06 (S.D.N.Y. 1986).

Petitioners argue, second, that the Employment Retirement Income Security Act, 29 U.S.C. § 1001, *et seq.* ("ERISA"), provides an alternative regulatory scheme. But ERISA applies to only two of the six named plaintiffs. Moreover, it does not reduce the risk of the instrument, *Reves*, 494 U.S. at 67; rather, ERISA only applies an alternative means of recovery for a percentage of the transactions – a factor also noted by the Second Circuit but ignored by petitioners. App. A-14.

Petitioners argue, third, that under New York State law, extensive statutory regulation of mortgages and mortgage brokers already exists. This ignores the fact that

it is the securities broker, not the mortgage broker (who is bankrupt), that plaintiffs seek to hold liable. It also ignores the fact that the investments at issue here, which are alleged to be "uncollateralized, speculative participations in mortgages", are not analogous to recorded mortgages obtained in face-to-face negotiations with a professional licensed under state law such as an attorney – also noted by the Second Circuit but ignored in the petition. App. A-12-14.

The securities laws provide a unique regulatory scheme and may be the only means by which plaintiffs can obtain a meaningful recovery. Twiste, who is bankrupt, was able to defraud plaintiffs, in part, because he was not subjected to adequate internal controls. App. B-2; D-12, ¶ 40; D-14-15, ¶¶ 44-45. The securities laws require corporations and individuals to implement adequate controls before they can hold themselves out as securities brokers and investment advisors soliciting funds from the general public. The securities laws attempt to enforce that requirement, in part, by imposing controlling persons liability on corporations and individuals who fail to implement adequate controls.

The Second Circuit was correct in recognizing that the securities laws, through the imposition of controlling persons liability, may be the only means by which plaintiffs can obtain a meaningful recovery in this case.

CONCLUSION

For the foregoing reasons, the writ should be denied.

Respectfully submitted,

STEVEN M. EDWARDS
DAVIS, SCOTT, WEBER &
EDWARDS, P.C.
100 Park Avenue
New York, New York 10017
(212) 685-8000

Attorneys for Respondents

October 11, 1994.